

**AUDIT OF THE
COMPETITIVE SERVICE OFFERINGS OF

NEW JERSEY NATURAL GAS COMPANY
Docket #GA02020100**

**SUBMITTED TO THE

NEW JERSEY BOARD OF PUBLIC UTILITIES
DIVISION OF AUDITS**

**SUBMITTED BY

OVERLAND CONSULTING**

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Chapter 1 - Executive Summary

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I. Introduction

This report describes the results of an audit of New Jersey Natural Gas (NJNG) Company's compliance with New Jersey Board of Public Utilities (BPU) rules, regulations and orders related to competitive services. The audit was conducted in the context of BPU dockets AA0202094 (generic) and GA02020100 (NJNG). The BPU rules and regulations concerning competitive services are codified in New Jersey Administrative Code Section 14:4, Subchapter 5 - Affiliate Relationships, Fair Competition and Accounting Standards and Related Reporting Requirements (Affiliate Standards). These rules and regulations formed the basis for audit compliance testing. This chapter of the report describes the conduct of the audit, restates the audit scope and objectives, summarizes findings and documents recommendations.

II. Audit History, Scope and Objectives

This audit was conducted pursuant to a Request for Proposal issued by the BPU on March 20, 2002. Overland was selected to perform the audit and signed a contract in July, 2002. We issued our first data request to NJNG on July 30, 2002. Our primary BPU contacts during the audit were Thomas Langbein, Bureau Chief, Management Audits, Arthur Gallin, Bureau of Management Audits and Albert Weierman, Bureau of Financial Audits. Messrs. Gallin and Weierman participated in the field work phase of the audit, including most interviews. Our primary Company contacts during the audit were Kevin Moss, Senior Vice President, Regulatory Affairs and Tracey Thayer, Director, Regulatory Policy.

We conducted audit field work at NJNG's Wall, New Jersey headquarters from September 9, 2002 through December 12, 2002. In total, we conducted interviews of 23 New Jersey Resources (NJR), NJR subsidiary and NJNG employees covering a range of topics relating to affiliate transactions and compliance with BPU Affiliate Standards. A list of interviews is shown in Appendix 1. We conducted audit analysis from September, 2002 through January, 2003. In total we issued 97 formal requests for data and information. A data request and response log for the audit is shown in Appendix 2. We submitted our draft audit report to the BPU on January 31, 2003.

The audit's scope, in accordance with the Request for Proposals, included a review of competitive services offerings and affiliate relationships and transactions. Audit objectives included a determination of the following:

- C Whether there is strict separation or allocation of utility revenues, costs, assets, risks and functions from those of its competitive service segments.
- C Whether the degree of separation is reasonable under the BPU's Affiliate Standards.
- C Whether there is cross-subsidization between the utility and competitive service segments.
- C The impact on ratepayers of using utility assets to provide competitive services.

- C The impact of competitive services on utility workers.
- C The impact of utility practices on the market for competitive services.
- C Whether recommendations from the previous audit have been fully implemented.

The period reviewed in this audit included NJR's fiscal years 2001 and 2002 (October 1, 2000 through September 30, 2002). In some cases, the report refers to or includes statistical information from fiscal year 2000 in cases in which it served as a reference point for the audit period.

III. Audit Report Contents

The audit report is organized in accordance with NJR's corporate structure and NJNG's affiliate relationships. NJNG is the primary subsidiary of New Jersey Resources Corporation (NJR), a public utility holding company. NJR's operations, services and transactions are conducted primarily within the following subsidiaries:

- C NJR Corporation, the parent company, contains NJR's Chief Executive, Chief Financial and Chief of Staff functions. NJR Corporation included six employees at the end of fiscal year 2002. Audit findings relating to NJR Corporate functions and cost allocations are discussed in Chapter 3 - Common Cost Allocations.
- C NJR Service Company (Service Company), a subsidiary established in 2001 to provide corporate financial, accounting, information, human resources and other administrative services to NJNG and other NJR subsidiaries. At the end of 2002, Service Company included 105 employees. Audit findings relating Service Company and related cost allocations are discussed in Chapter 3.
- C NJNG, the gas utility, provides a tariffed gas commodity and transportation services to approximately 430,000 New Jersey customers. NJNG had 553 employees at the end of fiscal year 2002. NJNG shares certain functions with affiliates. The cost allocations associated with these functions are discussed in Chapter 3. The functions themselves and related Affiliate Standards compliance issues are discussed in Chapters 4 and 5.
- C NJR Home Services (Home Services), an appliance services company, provides appliance repair and maintenance services to customers primarily within NJNG's service territory. At the end of fiscal year 2002, Home Services had 107 employees. Its relationship to NJNG, related shared utility services, its marketing and promotion activities, cost allocations and an analysis of potential cross-subsidization are discussed in Chapter 4.
- C NJR's Non-Utility Energy Affiliates consist of NJR Energy Services (Energy Services), NJR Natural Energy (Natural Energy) and NJR Energy Holdings. Of these, only Energy Services, NJR's wholesale gas marketing subsidiary, had active operations, employees and significant transactions with NJR and NJNG during the audit period. At the end of 2002, Energy Services had 13 employees. The relationships and transactions between NJNG and the non-utility energy affiliates are discussed in Chapter 5.

IV. Summary Audit Findings and Conclusions

The following discussion addresses the audit objectives stated in the Request for Proposals. A summary of all audit findings by topic is included at the beginning of each report chapter.

A. Applicability of Affiliate Standards to NJNG Affiliates

NJNG classifies its affiliates as “retail” or “non-retail.” Retail affiliates include:

- C NJR Home Services Company (Home Services) and NJR Plumbing Services, competitive service segments of NJR providing appliance installation and repair, discussed in Chapter 4.
- C NJR Power Services, currently inactive, intends to engage in “distributive generation opportunities.”

In 2001 NJNG classified NJR Natural Energy, which provided competitive gas commodity services, as a retail affiliate. In 2002, Natural Energy became inactive. The 2002 Compliance Plan lists Natural Energy as “non-operating” and its retail or non-retail status is no longer specified. NJNG considers other affiliates to be “non-retail.” Key non-retail affiliates include:

- NJR Service Corporation (Service Corp), which provides shared corporate services (discussed in Chapter 3).
- NJR Energy Services (Energy Services), which provides wholesale (interstate pipeline) gas supply, pipeline capacity and storage management services.
- NJR Capital Services, NJR Energy Holdings, NJR Energy and NJR Pipeline Company, a set of vertically integrated holding companies which own a 2.3 percent equity investment in the Iroquois Gas Transmission Line and Commercial Realty and Resources (CR&R), a company that is exiting the commercial real estate business.

NJNG established policies to govern the relationships and transactions between its affiliates in its Affiliate Standards Compliance Plan. NJNG’s 2002 Compliance Plan contains 39 affiliate and competitive services policy statements. For a majority of the policies addressing affiliate relationships and transactions, NJNG limits the applicability of the policy to “retail affiliates.”¹ Home Services is currently the only active affiliate considered to be retail.

The audit considered the relationships and transactions between NJNG and all of its affiliates. Although the audit included analysis of all affiliates with which NJNG had a significant relationship or transactions, it was not within the audit’s scope to determine whether individual affiliates should be classified as “competitive service segments,” or “retail affiliates.” It should

¹The 2002 Compliance Plan contains 39 policy statements. Of these 13 apply only to NJNG. Of the 26 that apply to affiliates or to NJNG’s relationships and transactions with affiliates, four apply to all affiliates and 22 apply to “retail affiliates.” Although the applicability of the policy is generally limited to retail affiliates, NJNG maintains functional separations and applies common cost allocations to all affiliates.

be noted that relationships and transactions with affiliates can affect the utility and its ratepayers regardless of whether NJNG considers the affiliate to be “retail”, “competitive” or otherwise subject to the BPU’s Affiliate Standards.

B. Accounting Separation Between Utility and Affiliate Revenues, Costs and Assets

1. Accounting Separation - Utility and Affiliate Activities - We found effective management and financial accounting separation between NJNG and the direct operations of its affiliates, including affiliates Home Services, Energy Services and the investment affiliates under the Capital Services / Energy Holdings umbrella (Chapters 3 through 5).
2. Accounting Separation - Corporate and Utility Activities - NJR maintained effective management accounting separation between NJNG functions and those corporate and administrative functions providing benefits to all subsidiaries (Chapter 3).
3. Common Cost Allocations - Attributable cost procedures attempt to allocate cost on a cost-causative basis. NJR and NJNG appear to be committed to attributable cost as a basis for most allocations of common cost. One exception is NJR’s continued use of relative levels of subsidiary equity to allocate certain corporate costs. Although attributable cost appears to be accepted in principle, some audit period allocations were inadequately supported by workpapers. We were not able to obtain sufficient workpaper support to determine whether Service Corp costs benefiting all affiliates were fully and properly allocated (Chapter 3).
4. Affiliate Transaction Internal Control - Control over transactions between NJNG and affiliates was adequate in some respects and requires improvement in others. Inter-company receivables and payables accounts were used effectively to control the flow of amounts owed and received for inter-company products and services. However, inadequate written procedures, a lack of inter-company service agreements between NJNG and specific affiliates and a lack of periodic itemized bills for affiliate services make it difficult to analyze the nature and amounts of services and products provided between NJNG and affiliates and represent control weaknesses (Chapter 2).

C. Functional and Management Separation Between NJNG and Affiliates

1. NJNG and Service Corp - In 2001, NJR moved 14 corporate and administrative functions benefiting all NJR subsidiaries into a newly-established service company, Service Corp. The establishment of Service Corp effectively separated utility functions from corporate and administrative functions common to all NJR subsidiaries (Chapter 3).
2. NJNG and Home Services - Management separation between Home Services and NJNG was adequate. Except for shared customer inquiry, which lacked system controls to prevent utility customer data from being used on behalf of Home Services, functional

separation between Home Services and NJNG in general, and between utility and appliance service technicians in particular, was adequate (Chapter 4).²

3. NJNG and Home Services Shared Customer Inquiry - Home Services shares NJNG's customer service ordering and inquiry function. Management represents that Home Services does not use NJNG's proprietary customer data. However, Home Services and NJNG share customer account numbers and the customer information system lacks controls to prevent service representatives from accessing utility customer data on behalf of Home Services (Chapter 4).
4. NJNG and Energy Services - Energy Services, a gas supply, capacity and storage services provider in the interstate pipeline market, is separate from NJNG for payroll purposes. However, Energy Services, which shares management and functions with the utility, is not well separated from the utility. NJNG represents that Energy Services does not sell gas or pipeline capacity to NJNG. Because of overlapping management and functional responsibilities, such transactions, if they occurred, would present a potential for conflict of interest. It is Overland's understanding that as a wholesale affiliate, Energy Services is not subject to BPU Affiliate Standards (Chapter 5).
5. Stagecoach - In 2001, Energy Services entered into a contract to sell gas storage capacity for eCorp, an affiliate of Central New York Oil & Gas, the owner of the newly-developed Stagecoach storage field in New York. Energy Services' risks and profits under the contract depend on its ability to meet storage sales quotas. NJNG bid for and purchased storage in Stagecoach. Because NJNG and Energy Services share management and certain functional responsibilities, NJNG's decision to purchase this storage presents a potential for conflict of interest. Nothing came to our attention to question the reasonableness of NJNG's decision to purchase Stagecoach storage; however, the issues affecting reasonableness are complex and may warrant detailed review. It is Overland's understanding that the BPU Staff and the New Jersey Ratepayer Advocate were informed in advance of NJNG's plans to bid for storage at Stagecoach (Chapter 5).
6. NJNG and Natural Energy - Natural Energy became inactive during the audit period. The separation of NJNG from Natural Energy is not currently relevant (Chapter 5).
7. NJNG and Energy Holdings - Energy Holdings and its subsidiaries were established for investment purposes and have no employees. Functional and management separation is not a relevant issue (Chapter 5).

D. Cross-Subsidization

1. Common Cost Allocations - For two of the three most significant sources of allocated costs, NJNG bore the following cost percentages in 2002: NJR corporate - 93 percent

² NJNG's Customer Service Representatives (CSRs) provide services to both NJNG and Home Services and have access to both utility and appliance customer information. NJR represents that CSRs do not use customer information from the utility side when providing ordering and inquiry services on the appliance side of the account. Home Services' Appliance Service Technicians do not have access to utility customer information.

and Service Corp - 94 percent. Although NJR's descriptions suggest that Service Company allocations are based on attributable cost principles, inadequate workpaper support prevented us from developing a conclusion about the reasonableness of Service Corp allocations or the existence of cross subsidies. We identified two circumstances in which NJNG appears to be cross-subsidizing Home Services costs by relatively small amounts. Specifically, Home Services is not paying its attributable share of the costs of maintaining NJNG's AS400 computer on which Home Services customer accounts are maintained. In addition, Home Services is not allocated an attributable share of collection costs incurred by the customer inquiry function. The discount that Home Services provides on accounts receivables it sells to NJNG is not enough to cover its share of collection costs. The amounts involved small enough that if they had been allocated to Home Services, they would not have eliminated Home Services' audit period profits; as such, under-allocation of the costs did not create price cross-subsidies (Chapter 3).

2. Transfer of Appliance Services Going Concern Value - When NJNG transferred its appliance business to Home Services, it transferred more than 100,000 appliance service customer contracts and associated cash flow. The discounted value of the cash flow associated with the contracts represented the going concern, or economic, value of the transferred business, something that would not have been given to a non-affiliate without compensation. Under a BPU Stipulation, NJR agreed to credit NJNG ratepayers for 40 percent, 15 percent and 10 percent of pretax margins generated by Home Services in fiscal years 2000, 2001 and 2002, respectively.³ These amounts could be considered compensation for going concern or brand value, but nothing in the Stipulation designates them as such and there is no basis for determining that the amounts compensated (\$439,612 for a business that generated pretax income of \$1.4 million in 2002) fully compensate NJNG for the business and brand value transferred. We were unable to reconcile the amounts paid under the Stipulation with Home Services' pre-tax margins. It should be noted that nothing in the Affiliate Standards requires compensation for the transfer of business value, nor does it appear that the BPU made the transfer conditional upon such compensation; as such, we do not classify it as a cross-subsidy under the Affiliate Standards (Chapter 4).
3. Brand Value - Home Services obtains value from its affiliation with NJNG and its shared use of the NJR brand and logo, which also derive their primary value from NJNG. As noted above, under a BPU Stipulation NJNG obtained \$439,612 in payments during the first three years of Home Services operations, an amount representing decreasing percentages of Home Services' pre-tax income. Although it is possible to attribute these payments to going concern value, to brand value, or to both, nothing in the Stipulation specifies this and the amounts to be paid are not supported by calculations of business valuation. Nothing in Affiliate Standards requires compensation for brand value. Under these circumstances, to the extent brand value was uncompensated or under-compensated, it does not appear to represent a cross-subsidy under BPU Affiliate Standards (Chapter 4).

³ OC-76. Stipulation in BPU Docket Nos. EX99090676 (Electric Discount and Energy Competition Act of 1999, Customer Account Services) and GM98060394 (NJNG Petition for Approval to Transfer Its Appliance Service and Repair Business to an Affiliate and Approval of Certain Service Agreements), p.13.

E. Ratepayer Impact of Using Utility Assets to Provide Competitive Services

NJR's competitive services were limited primarily to appliance repair and installation provided by Home Services. Home Services did not use NJNG's physical assets in any significant way; as such, the ratepayer impact of using physical utility assets for competitive services was minimal.

F. The Impact of Competitive Services on Utility Workers

It does not appear that the separation of Home Services from NJNG significantly affected utility workers during the audit period, either in terms of force levels or compensation.

G. The Impact of Utility Practices on the Market for Competitive Services

NJR did not compete in the New Jersey retail energy market in any significant way during the audit period. The only significant competitive service provided to the New Jersey market was appliance repair and installation. In providing appliance services, Home Services has several competitive advantages over smaller appliance service providers, including utility brand affiliation, economies of scale, use of NJNG's customer, dispatch and billing functions and the use of a mature utility customer information system (but not the utility's customer data). Competitive disadvantages, which we believe are minor by comparison, include the cost of certain corporate and administrative overheads not borne by smaller competitors and, for some potential customers, Home Services' affiliation with a utility may be a negative.

H. Implementation of Prior Audit Recommendations

We determined that NJNG fully implemented six of the recommendations adopted by the BPU as a result of the last audit. NJNG partially implemented a recommendation to develop an indirect cost allocation model (however NJR continues to use equity as an allocator for corporate costs). NJNG partially implemented a recommendation to develop a clearly written cost allocation manual and collect appropriate information to maintain it. The cost allocation manual, as written, is insufficient to explain the processes used in allocating corporate costs and NJNG does not maintain all of the the information necessary to support the allocations (Chapter 2).

In performing our audit, we also considered prior audit recommendations that were deferred or rejected by the BPU. To the extent we believed these recommendations continue to have validity, we have considered them in our current audit recommendations, discussed below.

V. Audit Recommendations**A. Affiliate Transactions Documentation, Auditability and Internal Control (Chapter 2)**

1. Develop service agreements between NJNG and each individual affiliate that describe the nature, terms and prices to be charged for inter-company services [Finding 2-II-A].

Inter-company services should be provided in accordance with agreed-upon terms and prices. Written inter-company service agreements should specify the nature of services to be provided, the transfer pricing basis for the service consistent with Affiliate Standards, and the terms under

which service is to be provided and recompensed. Separate agreements should be established for each inter-company service relationship. One agreement between and among all subsidiaries, such as the facsimile contract in NJR's current Compliance Plan, is of little no value. When executed, the agreements should be included in the Compliance Plan.

2. Prepare periodic (monthly or quarterly) itemized statements of inter-company services and charges (including allocations) for review by the business units and departments being charged for the services [Finding 2-II-A].

NJR subsidiaries providing inter-company services should provide periodic (monthly or quarterly) statements itemizing the services they provide and associated costs to the business units and departments that must bear the cost of the services. This should: 1) assist departments charged for services manage costs by controlling the level of inter-company services they use; 2) reduce misunderstandings and mistakes in affiliate charges and allocations (if they have the data, the units being charged are the most likely to find mistakes), and 3) enhance the auditability of inter-company transactions.

3. Adjust the board memberships of NJR, NJNG and other subsidiaries to comply with Affiliate Standards or obtain permission for variances from the BPU [Finding 2-II-B].

Oleta Harden, NJR Senior Vice President, General Counsel and Secretary, holds corporate officer positions in NJR, NJNG and the "retail affiliates." This is at variance with Affiliate Standards officer restrictions. NJR should either adjust Ms. Harden's memberships on NJNG or NJR and retail affiliate boards or obtain a letter from the BPU sanctioning the variance. The BPU should clarify whether Affiliate Standards board and officer restrictions apply to memberships and positions only with "retail affiliates" or to all non-utility affiliates, regardless of the wholesale or retail status of the services they provide.

B. Shared Services and Common Cost Allocations (Chapter 3)

1. Improve procedural documentation and workpaper support for Service Corp and NJNG shared function cost allocations [Finding 2-II-A, Finding 3-II-C].

Service Corp allocations are currently approximately \$15 million annually. Support for allocations from Service Company was not sufficient to establish a proper audit trail at the functional level between common cost pools and cost objectives (subsidiaries to which costs were allocated). Support initially provided for NJNG allocations was also insufficient to determine the cost basis for allocations. It took the draft audit report and a number of discussions with NJR's cost accountant to obtain the information needed to audit NJNG shared function cost allocations. Cost allocation documentation and support should be enhanced to include the following:

- C A complete procedural description of the nature of activities giving rise to common costs included in each cost pool.
- C A procedural description of the subsidiaries to which services costs are being allocated and why each allocated service is being charged to each subsidiary.

- C A procedural description of the activity basis for each allocation factor applied to each cost pool and how it relates to cost causation by the subsidiaries to which the cost is being allocated.
- C Workpaper support summarizing timesheet-based inter-company charges, including, by employee, a) the hours billed by each employee to each subsidiary, b) the hourly rate used to charge the employee's time to the subsidiary, c) support showing the calculation of the hourly rate and the costs included in it.
- C Workpaper support for the common costs included in each cost pool, including the financial data from the allocating subsidiary's ledger from which the costs are drawn. In the case of allocations based on estimates, the budgeted data or the actual financial data from the prior year used to develop the cost pool estimate should be used as financial support.
- C Workpaper support showing the allocation calculation, including a) the cost pool amounts, b) the allocation factor and, c) the amounts allocated to each subsidiary.
- C Workpaper support for all activity measures used to develop allocation factors. This would include for example, call activity reports supporting the allocation of customer inquiry costs (something that the audit requested and received) and the complete dispatch time study (something that was requested and not received.)
- C Workpaper support showing allocation results to itemized amounts charged to each subsidiary. These results should be traceable to subsidiary financial statements. If any additional steps (such as a true-up process) prevent a direct trace of itemized results to financial statements, workpaper support should be provided to fill the gap and enable the itemized results to be traced to the general ledgers of the cost-objective subsidiaries to which the allocations are billed.

Nearly all of the workpaper support can be maintained electronically. It should be maintained contemporaneously and indexed and organized so that an audit trail can be established with reasonable effort.

2. Discontinue the use of the equity allocator, retain at NJR the executive and other corporate costs associated with non-utility corporate development and allocate remaining "residual" or "unattributable" costs in proportion with costs directly assigned and attributed [Finding 3-II-D].

Certain corporate costs continue to be allocated to subsidiaries based on equity. As shown in Table 3-2, as a result of using the equity allocator, in 2002 Home Services was charged just 1/10th of one percent of NJR's annual audit fees, bank, legal, "strategic planning" and directors fees, and CEO and CFO salaries attributable to the corporate as a whole. Costs allocated based on equity should instead be allocated as follows:

- C Corporate executive and other costs currently included in the "equity" allocation pool should be divided into two categories: 1) costs relating to potential future operations (costs caused by corporate development efforts, including "projects" not currently producing revenue) and 2) costs of conducting current operations

of the corporation as a whole (NJR board meetings, annual audits and directors fees).

- C Corporate development costs, including the efforts of executive management directed at non-regulated projects in the consideration, planning or development stages should not be pooled as “NJR” expenses to be charged almost entirely to NJNG’s regulated operations based on equity. NJR should either retain these costs permanently at the corporate level or assign them to the subsidiary most likely to draw revenue when and if development efforts comes to fruition.
 - C Unattributable executive and governance costs relating to current operations of the “corporation as a whole” are residual costs and should be allocated in proportion with all other costs more directly assigned and allocated. For example, if, based on timesheets, the CEO, CFO and their staffs charge their time 60 percent to the utility, 20 percent to non-utility subsidiaries, 10 percent to corporate development and 10 percent to “corporation as a whole - current operations”, the costs assigned to last category are “residual” and should be allocated in proportion with the first three categories (i.e. in the ratio 60 / 20 / 10). To properly implement this, NJR will have to divide its “NJR” (corporate) timesheet category into two categories: one for future-oriented corporate development efforts, and one for activities relating to the current operations of the “corporation as a whole”, such as NJR board meetings and directors fees. This procedure should replace the use of the equity allocator for the costs of corporate time.
3. For each NJNG function shared with Home Services or another affiliate, identify, document, pool and allocate *all* common costs related to the function [Finding 3-II-E and 4-II-H].

As described in Chapter 3, NJR failed to fully allocate to Home Services the costs of customer inquiry (specifically, the costs of a computer on which both NJNG and Home Services customer accounts are maintained) and the costs of collection activities. We recommend that NJR document the nature and amounts of all shared NJNG activities and functions potentially or actually attributable to Home Services and other NJR subsidiaries in an improved cost allocation manual. Specifically, we recommend the costs of collection activities (if not covered by a revised receivables discount factor as explained in the recommendation below) and costs associated with the AS400 computer that are attributable to both NJNG and Home Services be allocated to Home Services. In general, any cost in a shared NJNG function deemed not to be attributable to the affiliate with which the function is shared should be fully documented with an explanation of why it is being withheld from allocation.⁴ All other costs should be pooled and allocated. Unit cost rates not based on the total actual costs incurred in a function should not be used as a basis for inter-company billing.

⁴ For example, because the specific costs allocated or not allocated were not documented, it took a significant amount of audit effort to eventually discover, after the draft audit report was released, that NJNG was not allocating a share of its AS400 costs to Home Services to cover the costs of the customer accounts that Home Services maintains on this computer.

4. Adjust the discount applied to Home Services receivables (purchased by NJNG) to properly reflect the entire cost of credit, collections and bad debts [Findings 3-II-F].

The current discount applied to receivables NJNG purchases from Home Services (½ cent on the dollar) is insufficient to cover the costs of credit, collection and bad debts. If the practice of purchasing receivables continues, NJR should identify and pool all of the costs of credit, collections and bad debts, determine Home Services' share based on relative amounts of appliance services and utility accounts receivable, and develop an appropriate discount rate. The resulting discount is likely to be approximately 1.5 percent, rather than 0.5 percent.

C. Shared Utility / Home Services Customer Functions and Databases (Chapter 4)

1. Establish controls to prevent NJNG customer service representatives (CSRs) from using NJNG's customer data in serving appliance services customers [Finding 4-II-D].

Home Services shares account numbers with the utility. Although NJR represents that utility customer data is not shared with appliance services, there are currently no controls to prevent CSRs serving Home Services customers from accessing utility data. At a minimum, NJR should install a system control to prevent CSRs from jumping between the utility and appliance screens of an account. The BPU should consider whether this is sufficient to meet the customer data separations requirements of the Affiliate Standards. If it is not, the BPU should consider the following additional steps: 1) Require NJR to separate the utility and appliance services customer databases and establish separate accounts, or, 2) Install system controls (either screen locks or database separation) and limit CSRs to either utility or appliance service calls, but not both, during a shift or sitting (period between breaks).

2. Include the prohibition against using utility customer data for appliance services in the NJR "Do's and Don'ts for Customer Service Representatives" policy [Finding 4-II-D].

NJR's Non-Discrimination policy states that NJNG will not share non-public customer usage information with Retail Affiliates. This prohibition should be restated in the CSR "Do's and Don't's" policy in terms that relate it to utility customer account information obtained from the customer information system.

3. The BPU should carefully consider the competitive consequences of granting NJR permission to transfer "No Heat" calls to Home Services and provide NJR with instruction based on its consideration [Finding 4-II-G]

NJR's 2002 Compliance Plan contains a CSR instruction to transfer "no heat" calls to Home Services during the heating season. The Compliance Plan indicates this is "pending approval by the BPU." The BPU should take into consideration that granting NJR's request may enable NJR to steer a majority of the "no heat" problems experienced by the customers in NJNG's service territory to Home Services. This could significantly enhance the competitive advantage Home Services already derives from its affiliation with NJNG and may amount to a violation of the Affiliate Standards prohibition against transferring leads to competitive services segments. NJR represents that CSRs are not currently transferring the calls in accordance with the instruction

because BPU approval has not been granted.⁵ Until and unless BPU approval is granted, we recommend removing the instruction from the CSR “Do’s and Don’t’s” policy and the Compliance Plan.

⁵ In addition, in responding to the Draft audit report, NJR provided a new draft of its “Customer Do’s and Don’t’s” policy removing the language addressing the transfer of “no heat” calls.

Chapter 2 - Organizational Overview, Internal Control, Board and Officer Restrictions and Implementation of Prior Audit Recommendations

Chapter 2 - Organizational Overview, Internal Control, Board and Officer Restrictions and Implementation of Prior Audit Recommendations

I. Introduction

This chapter provides an overview of New Jersey Resources (NJR) and its subsidiaries, an assessment of NJR internal controls governing affiliate transactions, an assessment of NJR's compliance with Affiliate Standards concerning shared corporate officers and board members and a review of New Jersey Natural Gas' (NJNG) implementation of prior audit recommendations.

II. Summary of Audit Findings

- A. Affiliate Transaction Internal Control** - We examined the internal controls in place to ensure that NJR's and NJNG's inter-company transactions are properly identified, measured and charged to the appropriate NJR subsidiaries. We found inter-company payables and receivables are appropriately used to account for and maintain control over inter-company charges. Inter-company payables balances appear to be appropriately settled (paid) on a regular basis. However, it is difficult to identify the nature and amounts of services flowing between NJNG and its affiliates. This is due to a lack of bills itemizing inter-company charges and to inadequate written affiliate service and allocation process descriptions. Improving the transparency of affiliate transactions with better descriptions and itemizations would enhance understanding, auditability and internal control. There are currently no service agreements between affiliates describing the services or the terms under which they are to be provided or the duties of parties on either side of the transaction. A facsimile contract included in Exhibit I to the NJNG Compliance Plan is too generic and far-reaching to be effective.
- B. Compliance with Affiliate Standards Board and Corporate Officer Restrictions** - In general, NJNG complies with Affiliate Standards restrictions governing board memberships and corporate officer appointments. One notable exception is NJR's Secretary and General Counsel, Oleta Harden, who serves on the boards of NJR and all of its subsidiaries. NJR's Chairman and CEO, Laurence Downes, and Senior Vice President of Energy Services, Joseph Shields, serve on both NJNG and affiliate company boards. It is our understanding that the affiliates they oversee are not subject to the New Jersey Board of Public Utility's (BPU's) Affiliate Standards because they do not provide services that meet the BPU's definition of "competitive services."
- C. Prior Audit Recommendations** - We examined the implementation of prior audit recommendations that were accepted by the BPU. Of eight accepted recommendations, we found NJR fully implemented six and partially implemented two.¹

¹ Schumaker listed nine recommendations. We classified two cost allocation recommendations as parts of the same recommendation and considered them together.

III. Overview of NJR's Corporate Structure

NJR is an energy services holding company headquartered in Wall, New Jersey. NJR provides retail and wholesale energy services from the Gulf Coast to New England and Canada.² Multiple sub-holding and operating companies reside under the NJR umbrella. See Attachment 2-1 to view an organizational chart showing NJR's corporate structure. NJR's significant operating subsidiaries include:

- C New Jersey Natural Gas Company
- C NJR Energy Services Company
- C NJR Retail Holdings Corporation
- C NJR Home Services Company
- C NJR Capital Services Corporation
- C NJR Service Corporation

A. New Jersey Natural Gas Company (NJNG)

NJNG is a regulated natural gas distribution company and NJR's primary subsidiary. NJNG provides tariffed gas and gas transportation to approximately 430,000 residential and commercial customers in northern and central New Jersey and maintains approximately 6,000 miles of underground pipe.³ NJNG also provides off-system sales and is active in the capacity release markets.⁴ Approximately seventy-one percent of NJR's employees work for the gas company.⁵

B. NJR Energy Services Company (Energy Services)

Energy Services is a marketing company that sells and manages natural gas, pipeline capacity and transportation and gas storage primarily in the interstate wholesale gas market. Energy Services' customers include other gas marketers, utilities and large users that draw gas directly from pipeline supplies. Energy Services marketing activities extend to states ranging from the Gulf Coast to New England and Canada.⁶ Energy Services had 13 employees at the end of fiscal year 2002.

C. NJR Retail Holdings Corporation (Retail Holdings)

Retail Holdings is a sub-holding company formed to contain subsidiaries NJR considers to provide retail services. Retail Holdings owns affiliates that operate (or have operated) in the competitive appliance services and retail gas markets.

² September 30, 2002 NJR Form 10-K.

³ September 30, 2002 NJR Form 10-K and NJR 2002 Annual Report.

⁴ September 30, 2002 NJR Form 10-K.

⁵ OC-16 and audit analysis.

⁶ NJR 2002 Annual Report.

1. NJR Home Services Company (Home Services) provides appliance maintenance and repair services to customers in northern and central New Jersey. Home Services offers appliance service contracts to customers. Specifically, the subsidiary offers installation and repair services for gas furnaces, hot water heaters, dryers, grills, lighting and electric central air conditioning units.⁷
2. NJR Plumbing Services (Plumbing Services) is a wholly-owned subsidiary of Home Services.⁸ Plumbing Services was created to enable the appliance services business to include water heater and gas and water pipe services that in New Jersey must be performed by a company owned in part by a licensed plumber.
3. NJR Natural Energy (Natural Energy) was established to provide the gas commodity in competition with other retail marketers. It operated in NJNG's territory until 2001 and had approximately 13,000 residential customers at its peak. It is not active.

D. NJR Capital Services Corporation (Capital Services)

Capital Services is a sub-holding company containing NJR's real estate and energy holding subsidiaries.

1. Commercial Realty & Resources (CR&R) is a real estate development company. In recent years NJR has de-emphasized real estate development. Currently, CR&R manages the maintenance and operations of NJR's Wall headquarters facility, including sub-letting non-NJR space. It is also developing and selling remaining commercial land purchased for investment purposes. Eventually, CR&R plans to exit the real estate development business entirely.⁹
 2. NJR Investments is involved in making various energy-related investments for NJR.¹⁰
 3. NJR Energy Holdings (Energy Holdings) is a sub-sub holding company that owns NJR Energy and NJNR Pipeline, NJR's energy investment companies.
- C NJR Energy - NJR Energy is a non-retail affiliate involved mainly in developing energy-related ventures through its pipeline company.¹¹

⁷ NJR 2002 Annual Report.

⁸ September 30, 2002 NJR Form 10-K.

⁹ Interview Notes: John Lishak, October 2, 2002.

¹⁰ September 30, 2002 NJR Form 10-K.

¹¹ September 30, 2002 NJR Form 10-K.

- C NJNR Pipeline - NJNR Pipeline owns approximately three percent of Iroquois Gas Transmission System. L.P, an interstate gas pipeline running from Canada to Long Island.¹²

E. NJR Service Corporation (Service Corp)

Service Corp was formed in 2001 to provide shared administrative services to NJR operating subsidiaries.¹³ It currently provides services grouped into 14 categories. Services include financial, accounting, human resources, communications and information technology.

IV. Audit Analysis

A. Affiliate Transaction Internal Accounting Control

The ability to audit affiliate transactions and demonstrate that subsidiaries are not cross-subsidized requires that inter-company transactions are recognized, identified, measured and properly recorded. Proper recognition and accurate recording of inter-company transactions depends on a functioning system of internal accounting controls. Our audit led to the following observations about internal controls:

1. Inter-company Control Accounts - The use of inter-company receivables and payables accounts to maintain accounting for affiliate transactions is an important accounting control. It appears that NJR effectively uses inter-company accounts receivable and payable accounts to identify and maintain control over inter-company transactions.
2. Timesheets - Much of the inter-company activity between a utility and its affiliates involves the provision of services by employees of one company for the benefit of another. Timesheets are a key element in helping to ensure that employee efforts attributable to specific affiliates are properly identified and recorded for cost assignment. We found that NJR, Service Corp, NJNG and Home Services all employ timesheets to separate efforts associated with their "home" entity from time attributable to other entities.
3. Inter-company Invoices - NJR does not itemize inter-company charges in a billing format. Periodic itemizing of inter-company charges enhances the transparency and auditability of affiliate transactions, thereby improving control and limiting the opportunity for mis-charges. Itemizing does not mean that inter-company bills must be prepared and printed out on paper. Often, the same spreadsheets used to develop inter-company allocations and journal entries can be used to send an itemization of charges from each charging or allocating affiliate to the manager or cost accountant responsible for the charges in each billed subsidiary.
4. Inter-company Service Agreements - Inter-company service agreements document the nature, terms and prices for inter-company services. In showing what affiliates are

¹² OC-14.

¹³ September 30, 2002 NJR Form 10-K.

receiving from one another and at what price, they enhance control by limiting opportunities for mistakes and misunderstandings. Inter-company agreements increase the transparency of inter-company transactions, enhancing the ability to understand and audit them. NJNG's Compliance Plan Exhibit I contains a facsimile inter-company service contract. It does not appear that this agreement has ever been activated. The contract is unsigned and appears to be intended to cover "all services to all affiliates." Even if activated, it is much too generic and far-reaching to be useful.

5. Affiliate Transaction Procedures - Attachments to Exhibit I of the 2002 Compliance Plan contain written procedures for affiliate allocation and billing. The procedures are important, but because they are attached to an unsigned facsimile contract, it is not clear that they represent procedures currently in effect. The procedures require timesheets for direct affiliate services and define "fully allocated cost" as the transfer pricing basis for "transferred services." However, they lack adequate descriptions of cost allocation processes; in particular they refer to allocated costs only in generic terms (labor, materials, etc). Except in the case of NJR Corporate allocations, the procedures omit descriptions of the functions being allocated. They do not adequately explain the basis for cost pools or the basis for cost allocations. While the existence of written procedures is a step in the right direction, in their current state, they are inadequate.
6. Inter-company Transaction Payment and Settlement - One of the areas the affiliate transactions procedures do address is accounting for inter-company receivables and payables and settlement of amounts due. Specifically, the procedure requires the transfer of net funds due on a monthly basis. We reviewed the balance sheets of all significant operating affiliates and determined that inter-company balances did not appear to be growing over time. This evidences the proper settlement of inter-company amounts due, an important element in the overall accounting control of affiliate transactions.

B. Compliance with Director and Officer Requirements

Affiliate Standards indicate that corporate officers and board members may not serve both the utility and its competitive services affiliates. Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements Section 14:4-5.5 (q) states:

An electric and/or gas public utility and the PUHC or related competitive business segments of its public utility holding company shall not have the same persons serving on the Board of Directors as corporate officers, except for the following circumstances:

1. In instances when these standards are applicable to public utility holding companies, any board member or corporate officer may serve on the holding company and with either the electric and/or gas public utility or a related competitive business segment of the public utility holding company, but not both the electric and/or gas public utility and a related competitive business segment of the public utility holding company.

Attachment 2-2 is a table showing the directors and officers for NJR as well as several of its sub-holding and operating companies. Analysis shows that one NJR Director (Laurence Downes, Chairman and CEO) and three NJR Officers (Downes, Oleta Harden, Senior Vice President, General Counsel and Secretary and Joseph Shields, Senior Vice President, Energy Services) serve as both utility and NJR subsidiary board members or Corporate Officers.

Mr. Downes serves on the NJR board, the NJNG board and the boards of Capital Services and Energy Holdings. He does not serve on the Retail Holdings board. The only "services" provided by the subsidiaries of these holding companies Mr. Downes serves are the real estate development services provided by CR&R. Mr. Shields is a Corporate Officer of NJNG, Energy Services and Energy Holdings. Energy Services provides services in the interstate wholesale gas market. It is Overland's understanding that these non-utility affiliates do not provide services that meet the BPU's definition of "competitive services"; as such, the participation of Mr. Downes and Mr. Shields as board members or corporate officers does not appear to be at variance with Affiliate Standards.

Ms. Harden serves as an officer and/or director for NJR and every one of its subsidiaries, including NJNG, Retail Holdings, Home Services and Natural Energy. Unlike Mr. Downes and Mr. Shields, Ms. Harden's board memberships appear to be at variance with the board and officer restrictions of the Affiliate Standards.

C. Implementation of Prior Audit Recommendations

The discussion below covers audit recommendations accepted by the BPU from the prior audit. To the extent deferred or rejected audit recommendations continue to apply in this audit, they are covered in Chapter 1, Executive Summary under the heading Audit Recommendations.

1. II-1: Resubmit the Compliance Plan after incorporating the findings and recommendations of this report - NJNG has satisfied this recommendation. NJNG resubmitted its Compliance Plan and appears to have incorporated the findings and conclusions of the Schumaker report. The Company filed plans in both June of 2001 and 2002.
2. III-3: Establish a service company within NJR as part of its reorganization - NJR has satisfied this recommendation. NJR established a service company, NJR Service Corporation, during the audit period.
3. IV-1: Establish procedures to ensure and document regulatory compliance for asset transfers, leases, or rentals - NJNG has satisfied this recommendation. The Company developed procedures regarding asset transfers, leases and rentals and included the procedures in its Compliance Plans.
4. V-2: Develop a method of apportioning pension costs between affiliates for employees within NJR who transfer - NJR provided a worksheet showing the allocation of pension expense for fiscal year 2002. The allocation results appear reasonable based on the number of employees and total compensation within each affiliate unit. Home Services, with approximately 11 percent of total employees, was allocated approximately 12 percent of fiscal year 2002 pension expense. Overland considers this recommendation to be satisfied.
5. VI-1: Develop a clearly written cost allocation manual incorporating these recommendations, distribute it to managers, and train managers to collect appropriate information to maintain it - NJNG has partially satisfied this recommendation. During the audit period, NJR developed a cost allocation manual for its service company. The manual, however, lacks clarity and sufficient detail to gain an understanding of the

Company's entire cost allocation process. The manual does not describe all of the cost allocation processes for shared corporate, utility and service company costs.

6. VI-3: Reduce dependence on a general allocation factor and VI-4: Develop an indirect cost allocation model that allocates costs fairly between the utility and non-regulated affiliates - We consider these to be the same recommendation and to be partially satisfied. NJR developed procedures to allocate the costs of 14 service company functions among subsidiaries. Schumaker determined that NJR's use of an equity based allocation method to allocate costs ("between NJR and its subsidiaries") that could not be directly allocated was a flawed methodology. We agree. The Company continues to use an equity component to allocate shared corporate costs but does not appear to use similar factors to allocate Service Company or shared utility costs to affiliates.
7. VI-5: Ensure that the inter-company cost allocations audit scheduled for early 2001 gets completed in a timely manner - NJNG has satisfied this recommendation. An internal cost allocations audit was performed in October 2001.
8. VI-6: Institute changes in spreading of costs between NJNG utility and appliance repair operations - NJNG has satisfied this recommendation. Specifically, to address the findings in Schumaker's report, NJNG conducted a time study of its dispatch department activity, began classifying all customer inquiry calls made to its call center, and began using positive time reporting for shared service company functions.

D. Audit Analysis of Cross-Subsidization

One of the key audit objectives listed in the BPU's Request for Proposals is to determine whether competitive services are cross-subsidized by utility services. The Affiliate Standards define cross-subsidization as follows:

"Cross subsidization" means the offering of a competitive product and / or service by [a] . . . public utility, or the offering of a product and / or service by an affiliate, which relies in whole or in part on the utilization of utility employees, equipment or other assets, and for which **full compensation** (via cost allocations or direct payment), as determined by the Board, has not been provided for the use of such . . . public utility assets, resulting in the inappropriate transfer of benefits from the utility ratepayers to the competitive product and / or service or affiliate [Emphasis added].

In order to evaluate cross-subsidization, we needed an objective benchmark to measure "full compensation". The only benchmarks available in the Affiliate Standards are the transfer pricing limitations established by market price and fully allocated cost, each of which may be applicable depending on circumstances. Taking circumstances into account (for example, whether an affiliate service was offered for sale on the open market), we used market price and fully allocated cost as the basis for assessing the existence of, and, when possible, calculating cross-subsidies.

1. Fully Allocated Cost

It is necessary to have a working definition of fully allocated cost in order to apply it to a test of cross-subsidization. As defined by Affiliate Standards, fully allocated cost includes

- Allocations of direct, indirect and other economic costs of assets utilized; and,
- Costs incurred directly or indirectly in providing competitive services.

In general, we interpreted “costs of assets utilized” to include depreciation and return (debt, equity return at the utility’s allowed rate of return and associated income tax) on assets employed, and rent paid to lease assets owned by others, including affiliates.¹⁴ In cases in which an affiliate’s “assets employed” were insignificant or in which the affiliate did not earn a profit, we ignored return on investment. We interpreted “costs incurred directly or indirectly” to include direct labor and associated benefits and payroll taxes, utilities, supplies, parts, vehicle operations and a share of the operating costs of shared utility and corporate functions calculated using an attributable cost allocation methodology.

2. Determining the Source of Cross-Subsidies

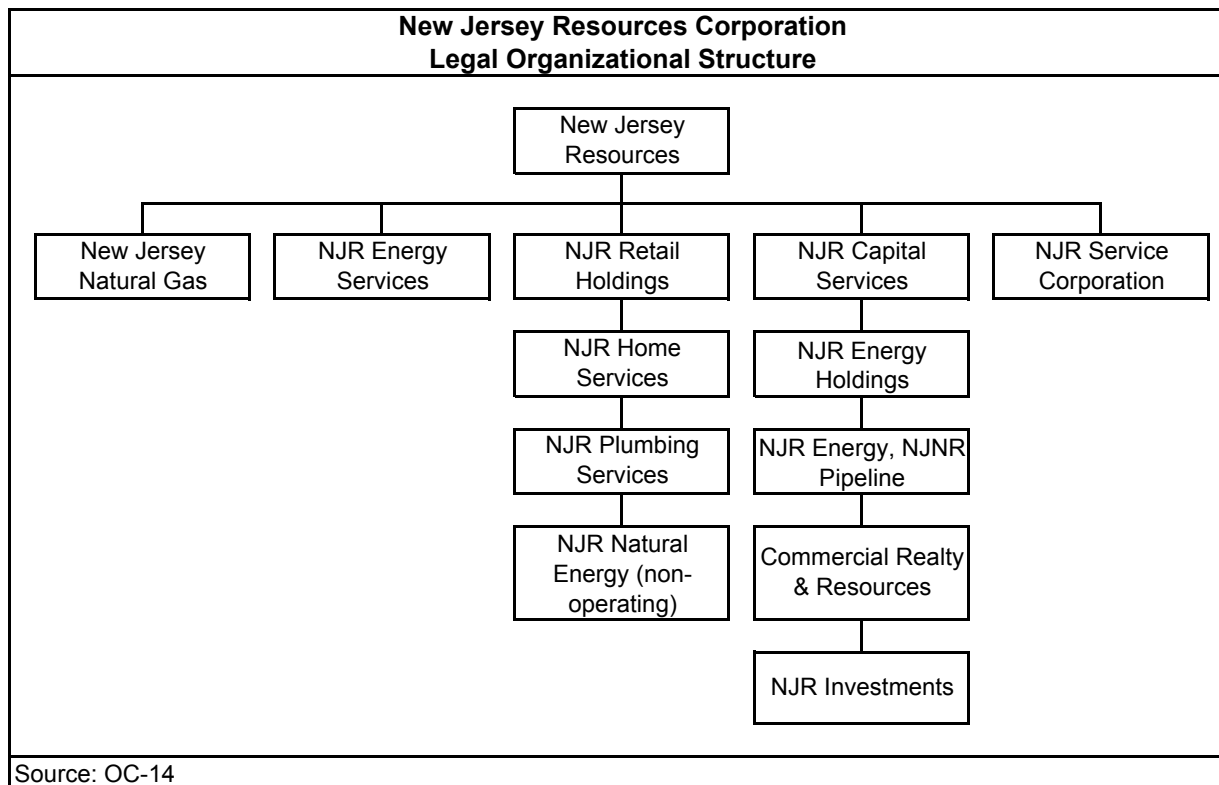
We also applied the following rules in defining and assessing the source of cross-subsidies:

- Subsidies Evidenced by Financial Losses - To the extent an affiliate lost money, its losses are considered to have been provided by its parent company and shareholders. Thus, affiliate losses are deemed to be cross-subsidization by shareholders. In general, we were able to quantify these cross subsidies when available financial results showed losses.
- Subsidies Evidenced by Unrecognized and Underestimated Affiliate Charges - To the extent an affiliate was not charged or under-charged for the utility and corporate functions that served it, the under-charged or under-allocated amount was a cross-subsidy provided by the other affiliates (mostly the utility) to which the costs were alternatively charged. We used attributable cost as the basis for assessing whether the allocation methodology was likely to have produced this cross-subsidy; however, in most cases involving allocations in which attributable cost was not properly used, it was not possible to quantify the amount of the cross-subsidy.
- Intra-Affiliate Subsidies Created by Price Discrimination (Appliance Services) - We considered whether price discrimination within the appliance services business (evidenced by certain promotions and discounts) created cross-subsidies between groups of customers within the business unit or between customers and the parent company’s shareholders. For example, senior-citizens discounts can represent a cross-subsidization of older customers by younger ones, or a cross subsidy of older customers by the parent company’s shareholders. Discounts for new appliance service customers, including free service contracts provided for some period of time, can represent a cross-

¹⁴ However, we ignored return on investment in cases in which the affiliate’s investment in capital assets was minimal.

subsidization of newer customers by existing customers, or a subsidy by shareholders.

We believe the test of whether subsidies created by discounts are reasonable under Affiliate Standards is whether the appliance unit is profitable overall. If it is profitable, then its prices on average are sufficient to cover its costs and it is logical to view discounts as subsidies between customer groups *within* the business unit. Discounts and promotions not designed to drive out competition are legal and widely practiced across the entire spectrum of retail businesses. However, it is not reasonable to paint all discounts and promotions with the same brush. Although we did not find evidence of excessive or predatory discounting in the gas appliance businesses we reviewed, such practices could occur even when the appliance business is profitable. As such, the BPU should consider the circumstances surrounding appliance services discounts and promotions to determine that are not designed to drive competitors out of a market.



New Jersey Resources Directors and Officers										
	NJR	NJNG	NJRRH	NJRHS	NRRNE	NJRES	NJRCS	NJREH	CR&R	NJRSC
	Holding Company	Gas Utility	Sub-Holding Company	Retail Affiliate	Non-Operating	Wholesale Affiliate	Sub-Holding Company	Sub-Sub Holding Co.	Development Company	Service Company
Directors										
Laurence M. Downes	■	■					■	■		
Nina Aversano	■									
Lawrence R. Codey	■									
Leonard S. Coleman	■									
Joe B. Foster	■									
Hazel S. Gluck	■	■								
James T. Hackett	■									
Dorothy K. Light	■									
William H. Turner	■									
Gary W. Wolf	■	■								
George R. Zoffinger	■	■								
Duncan Thecker	■									
Oleta J. Harden							■	■		
Glenn C. Lockwood							■	■		
Wayne K. Tarney			■		■					
Officers										
Laurence M. Downes	■	■				■	■	■		■
Oleta J. Harden	■	■	■	■	■	■	■	■	■	■
Glenn C. Lockwood	■					■	■	■	■	■
Gary A. Edinger		■								
Timothy C. Hearne, Jr.		■								■
Thomas J. Kononowitz		■								
Kevin A. Moss		■								
Joseph P. Shields		■				■		■		
Barbara C. Roma		■								
Hugo C. Bottino										■
Deborah G. Zilai										■
Wayne K. Tarney			■	■	■					
John Lishak, Jr.									■	
Notes: 1. The companies above are as follows: NJR - New Jersey Resources NJNG - New Jersey Natural Gas NJRRH - New Jersey Resources Retail Holdings NJRHS - New Jersey Resources Home Services NRRNE - New Jersey Resources Natural Energy Source: OC-14 and OC-69										
						NJRES - New Jersey Resources Energy Services NJRCS - New Jersey Resources Capital Services NJREH - New Jersey Resources Energy Holdings CR&R - Commercial Realty & Resources NJRSC - New Jersey Resources Service Corporation				

Chapter 3 - Cost Allocations

Chapter 3 - Common Cost Allocations

I. Introduction

New Jersey Resources (NJR's) regulated and unregulated subsidiaries share certain functions and costs. These functions and costs originate at the corporate level (NJR), within the recently established NJR Service Corporation (Service Corp) and within New Jersey Natural Gas Company (NJNG). In 2001, NJR established a service company to centralize certain functions and help separate them from the utility. NJR also developed an allocation procedure to distribute the costs of shared utility functions and service company functions between the utility and its affiliates. This chapter covers common costs and related allocation procedures.

II. Summary of Audit Findings

- A. Service Corp** - As a result of a prior audit recommendation, in 2001, NJR established a service company, Service Corp, to separate many of its shared corporate functions from the utility. Service Corp is composed of 14 functions, including information technology, corporate accounting, human resources, corporate communications, internal auditing and treasury.
- B. Attributable Cost Methodology** - In general, NJR's descriptions of its allocation procedures indicate that the Company uses an attributable cost methodology, starting with direct assignment using timesheets, to distribute shared function costs among subsidiaries. An attributable cost method attempts to allocate as much cost as possible based on causation using the most direct method possible. As such, attributable cost is a preferred method for fully allocating common and joint costs. Although NJR appears to have adopted attributable costs in principle, this does not prove that all of its cost allocation results are reasonable. In other words, an attributable cost basis for allocations is a necessary, but not sufficient, condition for obtaining reasonable fully allocated cost results.¹
- C. Support for Cost Allocations** - Some of NJR's common cost allocation results were inadequately supported by workpapers. Although written procedures in NJNG's Compliance Plan and certain workpapers indicate that NJR uses an attributable cost basis for many allocations, we were unable in some cases to evaluate the application of these principles or to establish a complete audit trail from cost source to cost objective. Of the three business units allocating common costs (NJR, NJNG and Service Corp), the Company initially produced adequate workpaper support only for NJR allocations. Until we submitted a draft audit report, support for most NJNG shared function allocations to NJR Home Services (Home Services) was limited to a workpaper showing the activity

¹ Other required conditions include proper assignment procedures for costs directly charged to subsidiaries (e.g. avoiding direct charges to the biggest, most often charged subsidiary when a cost is actually common and attributable to more than one subsidiary), and cost pooling procedures that properly consider all of the direct and indirect costs of activities.

basis for allocated units multiplied by a unit cost rate.² Support for costs embedded in the unit cost rates (key to assessing the reasonableness of the amounts allocated) was provided after the Company reviewed the draft audit report. However, even after the draft audit report was released and additional paperwork was provided, we were unable to obtain sufficient support to draw conclusions about the reasonableness of Service Corp allocations.³ Service Corp allocated more than \$15 million in common cost in 2002, 94 percent of which was charged to NJNG. Workpaper support for both Service Corp and NJNG shared services allocated costs needs improvement. In short, allocation workpapers should be maintained contemporaneously (so they can be provided as a unit when "allocations support" is requested by auditors) and should be properly explained and referenced so that the allocation processes and amounts can be effectively audited with a reasonable amount of effort.

- D. NJR Corporate Costs Allocated Based On Equity** - The cost of top corporate officers that cannot be directly assigned based on timesheets and certain other corporate costs (Board of Directors' fees, audit fees and similar corporate expenses) are allocated using relative subsidiary levels of accumulated equity. Using accumulated equity to allocate these costs is inconsistent with attributable cost principles.
- E. Customer Inquiry Costs Shared by NJNG and Home Services** - NJNG uses an attributable cost allocator - customer calls - to allocate the cost of its customer inquiry function to Home Services. We were initially unable to obtain workpaper support to explain an apparent discrepancy between the percentage of call center activity attributed to Home Services and the percentage of customer inquiry function cost actually allocated. When details were sorted out after the draft audit report was provided to NJR, we identified two problems with the allocation of customer inquiry department costs: 1) the customer service function's share of the O&M costs of the AS400 computer, on which both NJNG's and Home Services' customer data reside, is charged entirely to NJNG and not allocated to Home Services, and 2) customer inquiry collection call activity is attributed only to NJNG, rather than being allocated between NJNG and Home Services. The impact of not allocating Home Services its attributable share of AS400 costs is approximately \$100,000 annually, based on an estimated \$500,000 AS400 customer inquiry cost pool. The problem with unallocated customer inquiry collection activity costs is discussed below.

² We submitted several data requests for allocation support during the audit, none of which produced the support necessary to develop audit conclusions. After we issued the draft audit report, NJR produced additional documentation. We reviewed this and were able to obtain additional information and draw some additional conclusions from after conducting several detailed conversations with NJR's cost accountant.

³ Requests for corporate allocations support during the audit produced little useful support for Service Corp allocations. Following the release of the draft audit report, NJR provided additional documentation showing the total amounts allocated from all Service Corp departments combined to individual NJR subsidiaries. NJR also produced a large bundle of paper showing examples of the multi-step technical process of journalizing its Service Corp allocations. However, none of the many pages provided included the data necessary to establish an audit trail between amounts accumulated in individual Service Corp functions (e.g. human resources, legal, etc.) and their distribution to NJNG, Home Services, Energy Services and other cost objectives.

- F. Shared Credit and Collection Costs** - In addition to billing and remittance processing, NJNG performs a credit and collection function for Home Services. Instead of allocating credit and collection costs to Home Services, NJNG purchases Home Services' accounts receivable for 99.5 cents on the dollar. The amount Home Services pays through the 0.5 percent discount applied on the receivables purchased by NJNG appears insufficient to cover Home Services' share of credit, collection and bad debt costs. Specifically, factoring cost Home Services approximately \$86,000 in 2002. We estimate Home Services' share of credit, collection and bad debt costs to be approximately \$230,000.

III. Audit Analysis

A. Attributable Cost Principles and NJR's Cost Allocation Procedures

Most regulatory commissions in the United States require utilities to fully distribute, or fully allocate, common costs between regulated and non-regulated activities. To the extent possible, fully allocated common costs should be linked to cost objectives based on causation; that is, subsidiaries should incur a share of common cost proportional with the costs they cause to be incurred. An attributable cost methodology is guided by the following principles:⁴

- Costs should be directly assigned to cost objectives when possible.
- Costs that cannot be directly assigned should be assigned to homogenous cost pools (groupings of costs that can be logically attributed on a similar basis). When possible, costs in these cost pools should be allocated based on direct analysis of the origin of the costs.
- When direct analysis is not possible, costs should be allocated based upon an indirect, cost-causative linkage to another category.
- When direct and indirect analysis is not possible (as is the case with certain corporate governance costs, such as Board of Directors fees), the costs are "residual" and should be allocated based upon the combined ratio of all other costs directly assigned, directly allocated and indirectly allocated.

B. Analysis of NJR Shared Functions and Common Cost Allocations

NJR's shared functions are divided into categories based on the business units in which they originate:

- NJR Costs - Senior executive costs (CEO and CFO) and certain corporate costs, such as Board of Directors' fees and annual meeting expenses and certain corporate legal fees.
- Service Corp Costs - Costs for shared service company functions such as human resources, information technology, accounting, treasury and legal services.

⁴ For example, see 47 CFR, Part 64.901.

- NJNG Shared Costs - Costs for shared gas utility functions, including customer call center (service order and inquiry), billing and remittance processing, service dispatch and transportation maintenance.

1. NJR Costs

According to a workpaper supplied in response to our request for the corporate allocation model, NJR allocates approximately \$7.5 million annually in corporate costs.

- a. NJR's Corporate Time Sheet Allocations - The salaries of two corporate officers, the Chief Executive Officer (Downes) and the Chief Financial Officer (Lockwood), and their assistants (presumably) are charged directly to subsidiaries based on positive time recording. It appears that related payroll taxes, benefits, expenses and facilities costs (rent, utilities, etc) follow these timesheet allocations. Corporate dues, donations and insurance, some of which may be unrelated to officer time, are also lumped in and allocated based upon officer time reporting. The total directly charged was approximately \$3.1 million in 2002. Time that cannot be directly assigned to a subsidiary is charged to "NJR Corporation" and is redistributed to subsidiaries based on equity. Corporate timesheet allocation percentages for 2002 are summarized below.

Table 3-1 NJR Corp 2002 Timesheet-Based Allocations		
	As Recorded on Timesheets	After Redistribution of "Corporate" Time
NJNG	59.7%	93.1%
Commercial Realty	0.5%	1.6%
NJR Energy	1.0%	1.2%
NJR Energy Services	1.8%	3.0%
Home Services / Plumbing Svcs	1.0%	1.0%
NJR Natural Energy	0.0%	0.0%
NJR	36.0%	0.0%
Total	100.0%	100.0%
Notes:		
1. After redistribution of executive time charged to NJR Corp.		
Source: OC-7		

The use of timesheets to make direct assignments is consistent with attributable cost principles. The timesheet distributions made by officers during the audit period appear reasonable. However, the use of a historical equity allocator to redistribute officer costs charged to the "corporate" cost objective is not consistent with an attributable cost methodology. Because NJNG has been accumulating equity capital for decades, the equity allocator assigns nearly all of the cost of top officers' "general corporate" efforts to the gas utility, more or less defeating the purpose of directly assigning time using timesheets. As explained below, we believe officers' and Board of Directors' efforts are

driven by subsidiary profitability and future business plans, not by the accumulation of earnings from past decades. We do not believe the redistribution of the costs of top officers' current year "corporate" efforts based on historical book equity is reasonable.

- b. NJR's Corporate Accumulated Equity Allocations - Approximately \$4.5 million in annual corporate costs are distributed using an accumulated equity allocator. 2002 costs allocated using equity included the following:

Interest expense on corporate debt	\$2.0 million
Misc. bank, legal and "strategic planning" fees	\$0.6 million
Directors fees and annual meeting expenses	\$0.7 million
Audit fees and other miscellaneous costs	\$0.2 million
CEO and CFO salaries and related costs	
charged to the "NJR corporate" cost objective	<u>\$1.1 million</u>
Total Cost Allocated Using Accumulated Equity	\$4.5 million

The equity allocator applied to these costs is summarized below.

Table 3-2 NJR Corp Corporate Equity Allocator			
	2000	2001	2002
NJNG	93.8%	93.3%	92.8%
Commercial Realty	3.3%	3.2%	3.0%
NJR Energy	0.5%	0.4%	0.6%
NJR Energy Services	1.4%	2.2%	3.4%
Home Services / Plumbing Svcs	0.0%	0.0%	0.1%
NJR Natural Energy	1.1%	0.9%	0.1%
Total	100.0%	100.0%	100.0%
Source: OC-7			

We made the following observations concerning the equity allocation used by NJR:

- C Except for costs directly caused by relative levels of equity investment (such as investment banking fees paid to raise equity capital or the administrative costs caused by a stock split), relative levels of equity do not provide an "attributable cost" basis for allocating operating costs.
- C Equity is not a reasonable basis for dividing the costs of corporate officers' efforts that cannot be directly assigned to an affiliate. Corporate officers' efforts are driven by profitability and by plans for the future, not by capital accumulation from past decades.
- C Some of the corporate officer time that cannot be assigned directly to a subsidiary is probably attributable to business development. In many cases, the businesses being planned and developed have nothing to do with the regulated gas utility (and will not provide revenues to it); yet, using the equity allocator, the gas utility bears over 90 percent of the costs. The time spent by corporate employees on corporate development efforts should be retained by NJR (in the

corporate cost pool) until an existing or new subsidiary begins operations based on these development efforts. They should not be charged to current NJNG operations.

- C Balance sheet equity may not accurately reflect the relative levels of subsidiary capital. For example, some subsidiaries may be capitalized through means other than “equity,” such as inter-company loans or inter-company accounts payable. Omitting these sources of capitalization effectively understates capital-related costs attributable to subsidiaries not capitalized with equity.
- C Inter-company loans and inter-company receivables and payables balances provide a better basis for allocating corporate interest expense than equity.
- c. Support for NJR Corporate Allocations - NJR Corporate allocations were the only category of common cost allocations for which we were able to develop a complete audit trail.
 - C Financial support for cost pool amounts - The NJR Corporate allocation workpapers were supported by financial data from the general ledger.
 - C Cost pool amounts - Workpapers provided in response to OC-7 included cost pool amounts for the timesheet and equity cost pools.
 - C Basis for allocation and allocation factors - Workpapers show the calculations of timesheet-based direct cost assignments and the equity factors used in the allocations.
 - C Amounts allocated to subsidiary cost objectives - The results obtained by applying allocation factors to the cost pools were included in the workpapers supplied with OC-7.
 - C Financial support for subsidiary-allocated amounts - We attempted to tie the allocations to subsidiary financial statements. For 2002 and 2002 only, we found an NJNG O&M analysis which contained a line item for NJR allocations. An “O&M Analysis” in NJNG’s fiscal year 2002 financial statements shows \$5,877,756 in corporate allocations. The allocation workpaper shows a combined forecast and preliminary true-up allocation amount of \$5,859,710. Allowing for a small difference to be explained by final true-up, we consider these amounts to agree and consider NJR allocations to tie out to NJNG financial statements. We found a similar level of agreement between the NJR workpapers and Home Services’ 2002 financial statements.

2. Service Corp Shared Functions and Common Costs

In 2001, NJR established a service company, Service Corp, to house certain corporate functions benefitting more than one subsidiary. The table below summarizes these functions and their departmental expenses for fiscal years 2001 and 2002.

Table 3-3 Service Corp Departmental Costs - Shared Functions			
Dept. No.	Department Name	Cost Amounts	
		2001	10 Months 2002
7100	Training	\$ 474,669	\$ 375,238
7110	Communications	1,914,618	1,274,337
7111	Website Admin	-	166,590
7115	Internal Audit	393,080	368,765
7200	Legal/General Counsel	338,933	280,376
7210	Human Resources	2,886,672	2,375,770
7220	ROW/Claims	228,813	129,025
7270	Cont. Impr./Quality	388,184	371,301
7290	Facilities	244,494	205,052
7300	Purchasing	750,325	538,417
7520	Integrated Business Systems	3,249,448	2,210,981
7530	Treasury	525,644	642,926
7540	Accounting	2,935,961	2,859,160
7550	Corporate Accounting	489,179	360,350
7570	Office Services	976,782	727,639
7900	"Special Allocation"	1,167,402	-
Total Service Company Costs		\$16,964,204	\$12,885,927
Source: OC-21			

- a. Analysis of Service Corp Cost Allocation Procedures - We interviewed employees in the Integrated Business Systems (IBS). Based on our interview and a review of the workpapers we determined that an attributable cost approach is being used to distribute the costs of the information services and technology function. However, there is a significant amount of detail associated with the IBS allocation procedure. To some degree, IBS subsidiary cost allocations depend on two things: 1) departmental time assignments to information systems and 2) interpretations of the subsidiaries that benefit from those systems. Moreover, while the workpapers were sufficient to evaluate the allocation basis, they did not contain support for the cost pools to which allocations were applied, nor was the detail available to separate the resulting amounts charged by IBS to subsidiaries from other Service Corp departmental allocations to trace them to subsidiary financial statements. In summary, although our interviews suggest an attributable cost approach is used by IBS to allocate its costs, we were unable to fully test the procedure to determine whether it is functioning as described.
- b. Support for Service Corp Allocations - Apart from IBS, we received no support for the amounts charged or methods used to allocate cost from the other 13 Service Corp departments. As noted above, the Service Corp allocation procedure included in the NJNG Compliance Plan does not discuss these allocations. It does not even list the functions or departments being allocated. Following is a description of the elements missing from the Service Corp cost allocation audit trail.

- C Financial support for amounts to be allocated - It is necessary to be able to trace cost pools back to originating source data to determine that they are based on a complete set of actual costs. Service Corp's allocation pools are based primarily on the administrative functions performed by 14 Service Corp departments. We obtained the data presented in the preceding table from Service Corp's budget variance reports.
- C Support for cost pools, cost allocation methodologies and factors and allocation calculations - We were unable to obtain workpaper support for Service Corp cost pools. Except for IBS, we were unable to obtain workpapers with calculations showing how various amounts were allocated by Service Corp departments to subsidiaries. As such, we cannot draw conclusions about the reasonableness of any of Service Corp's allocations.
- C Financial support for subsidiary-allocated amounts - We were unable to trace amounts from Service Corp to financial data from the subsidiaries to which its costs are allocated. This is summarized below. About the only thing we can determine is that the annualized 2002 amounts going in to the Service Corp "black box," \$15,463,000 (\$12,886,000 times 12/10), approximate the amounts coming out, \$15,375,000, shown below.

Without workpapers supporting the Service Corp allocation process, the most we can do is observe the results of the allocation process for all 14 Service Corp departments on a combined basis as reflected in the financial results of each subsidiary.⁵ The results show that all but 6 percent of Service Corp's identified costs were charged to NJNG in 2002.

Table 3-4 Service Corp Amounts Charged to Affiliates				
Affiliate	2001		2002	
NJNG	Unknown	Unknown	\$14,416,579	93.8%
NJR Home Services	651,516	Unknown	515,184	3.4%
NJR Plumbing Services	-	Unknown	-	0.0%
NJR Energy Services	305,444	Unknown	321,599	2.1%
NJR Energy	65,129	Unknown	41,274	0.3%
NJR Natural Energy	137,561	Unknown	2,368	0.0%
NJR Power Services	14,231	Unknown	8,304	0.1%
NJNR Pipeline	2,920	Unknown	1,260	0.0%
Commercial Realty & Resources	Unknown	Unknown	68,879	0.4%
Total	Unknown	100.0%	\$15,375,447	100.0%
Source: OC-18 and OC-64				

⁵ As shown in the table, we cannot even do this for 2001.

3. NJNG Shared Costs

Home Services relies on the gas utility to provide it with customer service, billing, remittance processing, dispatch and transportation maintenance services. NJNG provided certain workpapers relating to NJNG / Home Services' shared services allocations. However, although we were able to trace some of the allocations to the general ledger, the workpapers initially supplied (before the issuance of the draft report) were generally inadequate for the purpose of determining the nature, amounts and financial support for the costs going into the allocations. The initial support was therefore insufficient to establish an audit trail between the source for amounts allocated (the costs originating on NJNG's books) to the allocated amounts recorded by the cost objective (Home Services). After NJNG provided additional workpapers, we were able to develop a better understanding of the shared NJNG costs and in turn, draw several conclusions about the reasonableness of NJNG to Home Services' shared services allocations.

Two items stand out as audit concerns:

- C NJNG buys Home Services' accounts receivable, obviating the need for allocating credit and collection costs. However, our analysis of credit and collection costs shows that at 99.5 cents on the dollar, NJNG is paying too much for these receivables. Stated another way, NJNG is not charging enough for appliance service credit and collection when it purchases receivables from Home Services at a discount of only ½ cent per dollar.
- C The costs associated with the maintenance of NJNG's AS400 computer database system (which is shared with Home Services) are not included in the cost pools for the shared customer service, billing, remittance processing, dispatch, or vehicle maintenance functions. Approximately \$500,000 of what NJNG calls "hardware / software maintenance" costs are excluded from the cost pools of the shared functions listed above.⁶

Because the functions shared by NJNG and Home Services are recorded on NJNG's books, any cost that fails to properly allocate to Home Services automatically reverts to NJNG.

- a. Customer Inquiry - NJNG provides "customer inquiry" services to Home Services, the appliance affiliate, from its call center. These services consist primarily of answering inbound customer calls. Customer inquiry can be subdivided into two primary functions: taking orders for new services and responding to inquiries and requests from existing customers. Costs for the inquiry department are allocated based on customer calls. A call classification system assigns calls to either Home Services or NJNG. We believe customer calls are the primary factor driving the call center's cost, and we agree that they provide a reasonable attributable basis for cost allocation.

Supplemental workpapers provided to support the NJNG / Home Services' customer inquiry allocation (received after the issuance of the draft report) show that costs charged to Home Services are based on a per call rate of \$4.76, including fringe benefits, for fiscal year 2002. With the exception of the AS400 costs mentioned above, the cost pool used to calculate the per call rate appears to include a full distribution of customer inquiry costs. Based on review of both the original and supplemental

⁶ Of this, approximately \$430,000 is associated with customer inquiry, \$70,000 with dispatch, and minor amounts with the other functions.

workpaper support provided by NJNG, the following points related to the allocation of customer inquiry costs arose:

- C Although the calls for which Home Services was charged on the workpaper appeared consistent with call volume reports showing Home Services is responsible for approximately 18 percent of total calls, the actual 2002 allocation to Home Services (\$456,821 for 11 months in 2002) is less than 9 percent of general ledger cost recorded for department 860 - Customer Inquiry. There is a similar problem with the 2001 allocation. The discrepancy most likely relates to a practice in which NJNG transfers billing related costs recorded in department 860 to accounts 45530 and 45531, the accounts that billing costs are recorded in. Approximately \$2,200,000 of billing related costs were transferred out of the department 860 cost pool in 2002. If the billing costs had been included to calculate the per call rate for the customer inquiry function and had that rate been used to determine the amount allocated to Home Services, the total allocation would have been approximately 18 percent of the general ledger cost recorded for department 860.
 - C Excluded from calls classified to Home Services are "collection" calls, which NJNG attributes only to the gas utility. Collection calls comprise nearly 20 percent of NJNG call center activity, none of which is allocated to Home Services. As discussed below, Home Services' share of the collection calls handled by the call center, together with other credit and collection costs, does not appear to be fully covered by the ½ percent of revenues Home Services pays NJNG to buy its receivables.
- b. Billing Costs - Home Services and NJNG share the gas utility's billing function. Workpapers indicate that Home Services' billing cost allocation is based on a predetermined rate per bill multiplied by the number of gas utility and appliance services bills. The initial billing workpaper for 2002 shows what appears to be a 49 cent per bill rate, excluding fringe benefits, multiplied by 595,337 bills for an annual Home Services' billing cost allocation of \$293,897. We were able to trace the 2002 "expense" portion of the billing allocation to a credit in NJNG's general ledger object account 45530 (billing expense), department 800 (customer service). The supplemental workpaper support provided by NJNG shows the components of the billing rate. The supplemental workpaper, however, shows what appears to be a fully distributed 56 cent per bill rate, including fringe benefits.⁷

Account 45530, the billing expense account, reveals that NJNG incurred \$2,015,513 in billing costs in the first 11 months of 2002 before the allocation to Home Services is credited out.⁸ Under this possibility, Home Services' \$268,130 allocation represents a 13.3 percent allocation of total billing costs. The amount allocated to Home Services is consistent with Home Services' 18 percent share of call volumes, taking into account the additional fact that many Home Services' customers are billed on cycles longer than one

⁷ The amount appears reasonable in comparison to what NUI's UBS subsidiary charges its affiliate Elizabethtown Gas for billing (49 cents per bill).

⁸ Based on analysis of trial balance data, OC-20.

month (explaining fewer bills than customers relative to NJNG). Based on the data provided, it appears that the billing cost allocation to Home Services is reasonable.

- c. Remittance Processing - NJNG's remittance processing costs are divided between NJNG and Home Services based upon a rate of 13.8 cents per remittance billed to Home Services.⁹ The number of remittances is set to equal the number of Home Services' bills. Based on audit analysis, it appears that Home Services is receiving an 11 percent allocation of remittance processing costs. This appears to be a reasonable share of cost compared with Home Services' share of total bills and customers, taking into account that many Home Services' customers choose billing cycles exceeding one month. The supplemental workpaper support indicated the components that were used to calculate the 13.8 cent rate. It appears that with the exception of the AS400 costs referred to above, the 13.8 cent rate represents a fully distributed cost per remittance.
- d. Dispatch - Prior to 2001, dispatch costs were allocated between NJNG and Home Services based on dispatch manager estimates of 65 percent to the gas utility and 35 percent to appliance services. Dispatch costs are currently allocated based on a time study of the dispatch department conducted in 2001. The study produces a 76 percent / 24 percent split between gas utility and appliance services subsidiaries.

Home Services' dispatch allocation is based on applying the 24 percent allocation rate to an hourly dispatch rate of \$73.54. The supplemental workpaper support provided by NJNG shows the components of the rate. As mentioned above, the costs related to the shared AS 400 database system are not included in the dispatch cost pool used to calculate the \$73.54 per hour rate. However, other than the excluded AS400 costs, it appears that the hourly dispatch rate represents a fully-distributed cost for the dispatch function.

- e. Transportation Maintenance - Home Services relies on NJNG's transportation department to perform maintenance and repairs on Home Services' vehicles. Vehicle maintenance labor is allocated based on mechanic hours spent on Home Services' vehicles. Vouchered (parts) expenses are allocated based on number of vehicles.

The supplemental workpaper provided to support the transportation maintenance allocation shows a \$95.47 hourly rate, including fringe benefits. The rate includes mechanic repair labor and overheads but does not include direct costs. The result is what NJNG calls a "loaded labor" rate. Other than the exclusion of AS400 costs, the hourly transportation maintenance rate appears reasonable.

- f. Credit and Collections Costs - Although NJNG performs billing and remittance processing for Home Services, the appliance services subsidiary is not allocated a share of the costs of NJNG's credit and collection department. In addition, as discussed above, costs associated with customer inquiry collection calls are not allocated between NJNG and Home Services; rather, they are borne entirely by NJNG.

⁹ The initial remittance processing workpaper provided by NJNG indicated a per remittance rate of 18.5 cents. Because the initial workpaper contains no support for the development of the 18.5 cent rate, it is not clear what cost component is driving the difference with the 13.8 cent rate in the supplemental workpaper.

The likely explanation for the lack of allocations related to collections activities is the internal procedure whereby NJNG purchases Home Services' receivables. Home Services indicated that NJNG pays 99.5 cents on the dollar for Home Services' receivables.¹⁰ This essentially means that Home Services pays NJNG ½ percent of revenue to cover the costs of collection and bad debts; or, stated in terms of cost allocations, NJNG allocates Home Services an amount equal to ½ percent of Home Services' revenues (about \$85,000 annually) for collections and bad debts. As shown in Attachment 3-1, we do not believe this allocation is sufficient to cover collections and bad debt costs imposed by Home Services.

¹⁰ Interview notes, Wayne Tarney and Roy Churchman, Home Services, December 10, 2002.

NJR Home Services 2002 Credit and Collections Analysis		
Home Services Revenue	Redacted	
Plumbing Services Revenue	Redacted	
Total Home and Plumbing Services Revenue	Redacted	
Receivable Factoring % Provided by New Jersey Natural Gas	Redacted	
Home Services "Factoring Cost" (0.5% of Revenue)		Redacted
Average Home Services Accounts Receivable (1)	Redacted	
Average Plumbing Services Accounts Receivable	Redacted	
Total Average Home and Plumbing Services Accounts Receivable	Redacted	
Average New Jersey Natural Gas Accounts Receivable (1)	Redacted	
Total Accounts Receivable	Redacted	
% of Accounts Receivable Related to Home Services	Redacted	
Customer Inquiry Department Costs (2)	Redacted	
Collection Call % of Customer Inquiry Department Total Calls	Redacted	
Customer Inquiry Department Costs Related to Collection Calls	Redacted	
% of Accounts Receivable Related to Home Services	Redacted	Redacted
Customer Inquiry Department Costs Related to Collection Calls Attributable to Home Services		
Central Credit and Collections Department Costs (2)	Redacted	
% of Accounts Receivable Related to Home Services	Redacted	
Central Credit and Collections Department Costs Attributable to Home Services		Redacted
Home Services Bad Debt Expense	Redacted	
Plumbing Services Bad Debt Expense	Redacted	
Total Home and Plumbing Services Bad Debt Expense		Redacted
Total Collections Costs Attributable to Home Services		Redacted
Difference Between Home Services "Factoring Cost" and Collections Costs Attributable to Home Services		Redacted
Notes: 1. Trial balance data only available through August 31, 2002. The average accounts receivable balances are based on an eleven month average. 2. Trial balance data only available through August 31, 2002. The departmental cost amounts are annualized to reflect an approximation of a full year of customer inquiry department and collection department costs. Source: OC-20 and OC-64		

Chapter 4 - NJR Home Services

Chapter 4 - NJR Home Services

I. Introduction

This chapter covers New Jersey Resources (NJR's) appliance services subsidiaries, NJR Home Services (Home Services) and its adjunct, NJR Plumbing Services (Plumbing Services). Home Services provides competitive appliance maintenance, repair and installation services to customers in New Jersey Natural Gas Company's (NJNG or gas utility) service territory. Home Services began operations in 2001 with employees, customers and assets transferred from NJNG upon approval from the New Jersey Board of Public Utilities (BPU). Plumbing Services was established to provide competitive appliance services for water heaters and certain other customer-owned pipe facilities that must be provided through a licensed plumbing company under New Jersey law.

II. Summary of Audit Findings

- A. Management Separation** - Home Services President, Wayne Tarney, reports to Laurence Downes, President and Chief Executive Officer of NJR. Mr. Downes is also the Chief Executive Officer of NJNG. This is currently the only management link between Home Services and the utility. Home Services' management is separate from the utility to the extent possible under the existing NJR executive organization structure.
- B. Functional Separation** - Except for shared customer inquiry (discussed in the next finding), functional separation between Home Services and NJNG is generally adequate. Appliance service technicians are functionally separate from their utility counterparts and a majority of appliance service technicians currently work from separate operating centers. Home Services has its own marketing employees. Dispatch, customer billing, remittance processing and transportation maintenance functions shared with NJNG do not pose obvious competitive problems.
- C. Accounting and Asset Separation** - Home Services maintains its own set of books. The Company's accounts are not commingled with those of the utility. Appliance service trucks, tools and parts are maintained separately from the utility.
- D. Shared Customer Data** - Although NJR represents that Home Services does not use the utility's customer data, system controls over account access by customer service representatives in the shared customer inquiry function are insufficient to prevent utility customer service data from being used for Home Services' benefit. Home Services and NJNG share the same account number. Customer service representatives (CSRs) have access to both sets of information (appliance and utility). NJNG has not implemented system controls to inhibit or prevent CSR access and use of competitive and utility account data during the same customer call. Although NJNG's Non-Discrimination policy prohibits NJNG from sharing non-public customer information with a Retail Affiliate, NJNG's customer service representative policy (Exhibit C in NJNG's Compliance Plan) is silent with respect to CSR access to both competitive and utility information in the customer account.
- E. Going Concern Value of The Appliance Business** - When NJNG transferred its appliance business to Home Services, it transferred more than 100,000 appliance

service customer contracts and the cash flow associated with those contracts. The discounted value of the cash flow associated with the contracts represented the going concern, or economic, value of the transferred business. Under a BPU Stipulation NJR agreed to credit NJNG ratepayers for 40 percent, 15 percent and 10 percent of pretax margins generated by Home Services in fiscal years 2000, 2001 and 2002, respectively.¹ This compensation could be attributed to going concern or brand value; however, nothing in the Stipulation designates it as such and there is no basis for determining that the amount (\$439,612 over three years for a business that generated pretax income of \$1.4 million in 2002) fully compensate NJNG for the business and brand value transferred. Nothing in the BPU's Affiliate Standards requires compensation for the transfer of business value, nor does it appear that the BPU made approval of the transfer of appliance services conditional upon such compensation.

- F. **Brand Value** - Home Services derives competitive value from its affiliation with NJNG and from its use of the NJR brand. The value of the NJR brand derives primarily from its primary subsidiary, NJNG. As noted above, under a Stipulation NJR agreed to credit ratepayers for a percentage of Home Services' margins in its first 3 years of operation. This could be attributed to brand value, going concern value, or both. This compensation will end after fiscal year 2002. Nothing in the BPU's Affiliate Standards requires compensation for the value derived from the utility brand or affiliation with the utility.
- G. **Customer Referrals** - NJNG's policy guidelines for customer service representatives contained an instruction to transfer "no heat" calls to Home Services during the heating season when the CSR was able to determine the problem was with the customer's appliance, rather than with their utility service. In 2002, the instruction was followed by the parenthetical "Pending Approval by the BPU." In 2001, it was followed by "By Special Permission of the BPU." NJR represents the policy is pending and that CSRs have not transferred "no heat" calls to Home Services based on the instruction. The transfer to Home Services of "no heat" calls attributable to appliances could significantly enhance the competitive advantages Home Services already has with respect to smaller competitors and may amount to a violation of the Affiliate Standards prohibition against transferring leads to competitive services segments.
- H. **Entity Level Cross-Subsidization** - Based on 2002 accounting results which show a \$1.4 million pre-tax operating profit, Home Services *prices* appeared high enough overall in 2002 to avoid being cross-subsidized. As described in Chapter 3, the workpapers NJR provided to support its allocations were insufficient to determine whether Home Services received a fully allocated share of the costs of Service Corp. As noted above Home Services shares certain utility functions. It appears Home Services was not charged a fully-allocated share of certain shared customer inquiry and credit / collection costs. To the extent that NJNG recorded certain costs that should have been charged or allocated to Home Services, the mis-charged or mis-allocated *costs* were cross-

¹ OC-76. Stipulation in BPU Docket Nos. EX99090676 (Electric Discount and Energy Competition Act of 1999, Customer Account Services) and GM98060394 (NJNG Petition for Approval to Transfer Its Appliance Service and Repair Business to an Affiliate and Approval of Certain Service Agreements), p.13.

subsidized by NJNG. However, it does not appear these cross subsidies were significant enough to affect Home Services' service *prices*.²

- I. **Service Level Cross-Subsidization** - A review of Home Services prices in various categories (service contracts, installations and chargeable non-contract work) shows that prices appear high enough in all major categories to prevent cross-subsidization. Prices for hourly chargeable work are also high enough to substantially cover Home Services' fully-allocated costs. Chargeable work accounts for a relatively small portion of Home Services' overall revenue.

III. **Audit Analysis**

A. **Operations and Financial Summary**

NJNG provided tariffed appliance services for a number of years prior to the inception of Home Services. In 1998, NJNG began placing employees providing gas utility "responder" and "appliance" services in separate groups. Between 1998 and 2000, there were 3 sections in the NJNG department responsible for appliance repairs: 1) first responders (who also did leak checks during idle time), 2) utility service turn on / turn off, and 3) appliance repair.³ On November 11, 2000, the BPU approved a stipulation that included the transfer of the appliance services from the utility into a subsidiary of the holding company.⁴ The transfer was accomplished on December 11, 2000 and NJR Home Services (Home Services) initiated operation as a separate subsidiary.⁵ NJNG initially transferred 62 utility employees to Home Services. By the middle of 2001, Home Services included nearly 100 employees. Below are the summarized combined financial results for Home Services and Plumbing Services for 2001 and 2002.

² *Prices* may be high enough to avoid cross-subsidy, if, when cross-subsidized costs that should have been charged to Home Services are added to the books, Home Services still shows a profit. Based on our analysis of cost allocations, we believe 2002 operating profits were high enough so that mis-allocated costs, if they were properly charged, would not have changed Home Services' recorded profit to a loss. Thus, even though NJNG may have subsidized certain shared services costs attributable to Home Services, prices were still high enough to avoid an anti-competitive price cross-subsidy. We cannot draw a firm conclusion about 2001, because profitability was lower; however, even allowing for under-charged common costs in 2001, it is unlikely that Home Services' prices reflected any significant cross-subsidy.

³ Massaro Interview, Sept. 13, 2002.

⁴ OC-52.

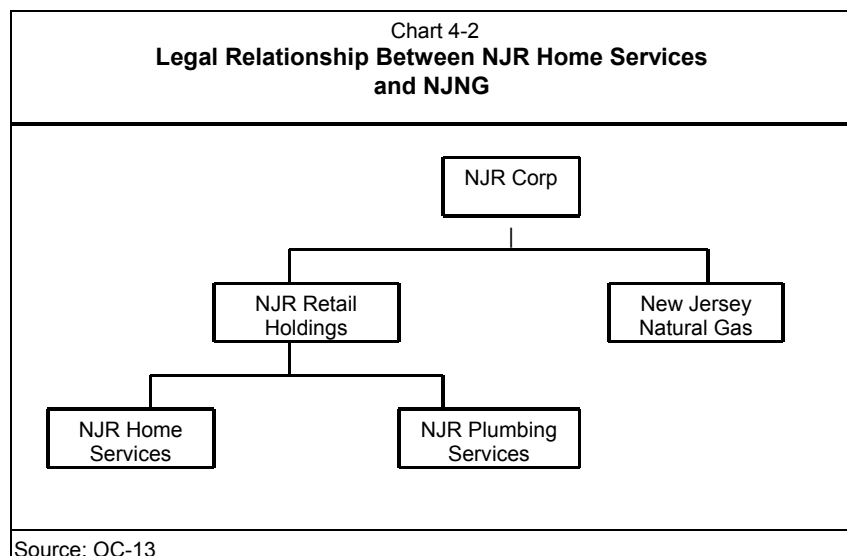
⁵ NJNG Affiliate Standards Compliance Plan (OC-14).

Table 4-1 Home Services and Plumbing Services Combined Summarized Financial Results		
	2001	2002
Contract Revenue		
Time and Material Revenue	Redacted	Redacted
Appliance Installations	Redacted	Redacted
Generator Sales and Installations	Redacted	Redacted
Duct Cleaning	Redacted	Redacted
Plumbing Sales	Redacted	Redacted
Other Income	Redacted	Redacted
Total Revenue	Redacted	Redacted
Direct Appliance Expenses	Redacted	Redacted
Direct Plumbing Expenses	Redacted	Redacted
Selling, General and Administrative Exp	Redacted	Redacted
Inter-Departmental Charges	Redacted	Redacted
Depreciation and General Taxes	Redacted	Redacted
Total Operating Expenses	Redacted	Redacted
Income Before Income Taxes	Redacted	Redacted
Income Taxes	Redacted	Redacted
Net Income	Redacted	Redacted
Source: OC-18 and OC-64		

B. Organization

1. Legal Organization

Home Services is an operating subsidiary of NJR Retail Holdings, a legal entity established to own affiliates that NJR classifies as providing non-utility retail services. The relationship between Home Services and the gas utility is summarized in the chart below.



2. Functional Organization

Home Services contained the following departments and force levels during the audit period.

Table 4-3 Home Services - Departmental Structure				
Business Unit	Dept No.	Department	2001 Employees	2002 Employees
HS	2715	Northern Division Appliance Svc	11	10
HS	2725	Bay Division Appliance Svc	13	0
HS	2730	Central Division Installation	0	10
HS	2735	Central Division Appliance Svc	16	28
HS	2750	Ocean Division Installation	0	9
HS	2755	Ocean Division Appliance Svc	31	28
HS	2800	Customer Service Dept	24	11
HS	2810	Stores Dept	0	8
PS	3735	Plumbing Central Division	0	2
PS	3800	Plumbing Management	1	1
Total			96	107

Source: OC-24

C. Separation From the Utility

1. Management and Functional Separation

Wayne Tarney, President of Home Services, reports directly to Laurence Downes, Chief Executive Officer of NJR. Mr. Downes is also President of NJNG, the utility.

Home Services field operations (appliance service technician and stores) departments were separated from NJNG at the end of 2000. Home Services has its own Director of Marketing and appears to do all of its own planning, marketing, business development and customer satisfaction measurement. Home Services shares NJNG's customer ordering and inquiry, service dispatch, billing, remittance processing and collection functions. Except for the shared customer inquiry function, which presents opportunities for NJNG's CSRs, as agents for Home Services, to use utility customer information for Home Services' benefit, the functional separation between Home Services and NJNG appears adequate. Customer inquiry is discussed below.

2. Accounting Separation

Home Services maintains its own set of books. Both Home Services and the utility share cost distributions from NJR Service Corporation (Service Corp), which provides corporate governance and administrative services and from NJNG, which provides customer service.

3. Physical Assets

At Home Services' inception, NJNG transferred trucks, tools appliance parts and office furniture to Homes Services at book value.⁶ Service Corp's physical assets and NJNG's customer services assets (primarily computers, furniture and other office equipment in both cases) are indirectly shared with other subsidiaries, as are certain NJNG buildings (discussed below). Home Services represents that it currently leases many of its own trucks and will continue to do so going forward. There should be no significant physical asset transfers from the utility in the future.⁷

4. Information and Information Systems

Home Services relies directly on the following shared NJR information systems:

- C JD Edwards general ledger and related accounting modules (payroll, accounts payable)
- C JD Edwards customer information system and human resources modules
- C Field Order Dispatch (FODs) - a system that controls field force work and includes wireless remote devices that share appliance service order and job information with a central computer.

Home Services and NJNG share a customer service system and the employees that access customer data. Because a lack of system controls provides employees in this joint customer function access to both utility and appliance customer data within the same accounts, there is potential for utility customer data to be used for the benefit of Home Services. NJR represents that this is not done.

5. Physical Separation

With the exception of customer service and dispatch, the employees directly responsible for Home Services' operations are separated departmentally from employees of NJNG. In the Spring of 2001, Home Services established its own service facility in Dover to provide service to the northern part of NJNG's service territory.⁸ Beginning in the summer of 2002, Home Services began renting space in a Red Cross building in Tinton Falls to provide service in the southern part of NJNG's service territory. Appliance service technicians in Ocean and Manahawkin continue to share operating facilities with the gas utility. Home Services indicated that for operational and productivity reasons, it will move these technicians to their own space when suitable space is found.

⁶Interview notes, Tom Massaro, Lester Davis, September 13, 2002.

⁷ Ibid.

⁸ Massaro Interview.

D. Marketing and Promotion

This discussion covers marketing and advertising. Section F below contains a further discussion of marketing and promotion issues as they relate to the shared NJNG / Home Services Customer Inquiry function.

1. Marketing

Home Services marketing responsibilities are contained in its Customer Services department. This department has the following marketing employees:⁹

- C Director - Marketing and Business Development - Directs all Home Services' marketing activities, oversees product line management, strategic planning and development of new products and services, preparation of the annual marketing plan and revenue budget, and supervises other marketing employees and activities.
- C Manager - Marketing Services - Plans marketing campaigns, interfaces with advertising agencies, oversees direct mailing activities, manages the website and coordinates customer service terms and conditions.
- C Competitive Services Analyst - Maintains operating data and prepares related reports, analyzes service and revenue trends, performs data analysis, assists in preparation of Home Services' financial statements and manages the use of the FODs system.
- C Customer Satisfaction Coordinator - Coordinates the customer satisfaction program (an ongoing customer survey program), follows up on "negative" surveys, reviews and responds to customer correspondence.

NJNG's Compliance Plan (Item III - Non-Discrimination) contains a policy that states NJNG will not provide Retail Affiliates (Home Services) with assistance, aid or services related to customer enrollment, marketing or business development. Additionally, the policy states NJNG will not share marketing or analysis reports with Home Services.

2. Advertising

Home Services advertises in the Yellow Pages. Home Services represents that the ads contain the disclaimer that "Home Services is not the same company as New Jersey Natural Gas Company, the utility".¹⁰ Home Services also maintains its own section on NJR's internet website. The website also contains the disclaimer, as do Home Services' business cards. It is noteworthy that the disclaimer, required by the Affiliate Standards, appears to have the consequence of reinforcing the affiliation between the utility and Home Services (i.e., it is an advertising tool). Home Services represents that it does not use the gas utility's billing envelope

⁹ OC-54.

¹⁰ Interview notes, Tarney and Churchman.

for advertising. NJNG indicates it does not permit Home Services' competitors to place inserts into its billing envelopes.¹¹

3. Customer Data

Although Home Services shares the gas utility's customer information system, Home Services represents that it does not use the system's customer data for marketing purposes. Instead, Home Services stated that they rent a 200,000-name mailing list prepared by Red Flannel, an advertising company.¹² Home Services also maintains its own database of approximately 125,000 appliance service contract customers, which it inherited from NJNG at the inception of its operation. The source of this data was the utility.

4. Utility and Corporate Brand Association

Home Services is linked to NJNG through the NJR corporate name. The Home Services' brand logo contains the NJR logo (the letter 'N' with an embedded gas flame), the Home Services' name, and the words "A New Jersey Resources Company." Home Services' affiliation with the utility is its most significant competitive advantage over smaller competitors. It is not clear that brand identity provides a competitive advantage over larger retailers, who may have nationally recognized brands.

E. Affiliate Transactions - Shared Services Provided by NJR, Service Corp and NJNG

Home Services receives shared corporate, service company and utility services. These are summarized in the table below. Common cost allocations are discussed in Chapter 3.

¹¹ Because Home Services is a subsidiary of the holding company, it cannot use the billing envelope unless NJNG also allows competitors to use it.

¹²Interview notes, Wayne Tarney and Roy Churchman, December 10, 2002.

Table 4-4 Home Services Shared Services and Functions			
Shared Functions / Services	FY 2002 Cost Allocation Procedures		
	Dept(s) Providing Service	Are Shared Benefits Recognized?	Do Cost Charging Methods Appear to be Appropriate?
<u>Shared Utility Services (1):</u>			
Customer Service	800, 860	Yes	Yes (3)
Billing and Remittance Processing	890	Yes	Yes
Credit and Collections	840	Indirectly (2)	-
Dispatch	770	Yes	Yes (3)
Transportation Maintenance	980	Yes	Yes
<u>Shared Service Company Services (1):</u>			
Purchasing	7300	Yes	Unknown
Facilities	7290	Yes	Unknown
Treasury, Accounting, Corporate Accounting & Internal Audit	7530, 7540, 7550, 7115	Yes	Yes
Communications and Website Administration	7110, 7111	Yes	Unknown
Legal/General Counsel	7200	Yes	Unknown
Human Resources and Training	7210, 7100	Yes	Yes
Information Systems	7520	Yes	Yes
ROW/Claims	7220	Yes	Unknown
Continuous Improvement/Quality	7270	Yes	Unknown
Office Services	7570	Yes	Unknown
<u>Shared Corporate Services:</u>			
Executive and Other	100	Yes	Yes(4)
Notes: 1. Includes functions directly providing a service to the NJ Appliance Services business unit and corporate functions from which NJ Appliance Services and other NJR business units derive a general benefit. NJR did not provide workpaper support for most of these allocations. 2. Shared credit and collection is indirectly recognized as NJNG purchases Home Services' receivables for 99.5 cents on the dollar. However, it does not appear that NJNG receives enough of a discount to cover Home Services' share of credit and collection costs. 3. Although the allocation method appears appropriate (i.e. attributable) lack of support prevents audit testing of the cost allocations. 4. A portion of shared corporate costs are allocated based on positive time reporting done by NJR executives. However, time not attributable to specific affiliates ("NJR holding company time") is then allocated to affiliates based on the equity each subsidiary contributes to total NJR equity. This shifts the majority of NJR holding company time and cost to the utility. Source: OC-6 and Audit Analysis			

F. Competitive Analysis of Shared Customer Inquiry

Customer inquiry includes call center activities such as order taking, calls concerning service problems and response to customer questions. A call categorization system within NJNG's automatic call router divides calls between NJNG and Home Services by type of call as follows:

<u>Utility</u>		<u>Home Services</u>	
10	Utility billing	55	Service
20	Utility service	65	Billing
30	Collections		
40	Gas leaks		

The routing of calls to customer service representatives (CSRs) can be controlled and is managed based on CSR training. Approximately one third of the CSRs are trained to take calls for both NJNG and Home Services. Call center costs are allocated based on categorized calls. In order to ensure correct cost allocations, calls must be re-routed when customers make an incorrect selection.¹³

1. Access to Appliance and Utility Customer Data

Home Services and NJNG customer accounts are linked by the same account number. CSRs responding to Home Services' service order and inquiry calls have access to utility customer data. There are no system controls to lock out the data on the gas utility side of the account when customers call on behalf of their Home Services' account. With no system controls, a CSR trained to handle both Home Services and utility customer issues has the ability to easily access customer data from the utility side to make recommendations on the appliance side.¹⁴

There are at least three potential solutions to this control problem that fall short of entirely separating the appliance and utility customer functions:

- C Install a system control to prevent CSR movement between utility and appliance services account screens (the minimal solution).
- C Separate the appliance services' and utility services' customer databases and account numbers. Install a system control to prevent opening both utility and appliance service accounts at the same customer address.
- C Install both system controls and limit CSR call routing to either appliance or utility calls, but not both, on a given shift or at a given sitting.¹⁵

2. Customer Service "Fair Competition Guidelines"

Exhibit C to NJNG's Compliance Plan contains a written policy entitled "Fair Competition Guidelines - Do's and Don't's for Customer Service Representatives." Most of the guidelines in

¹³ Overland observed call center activities by listening in on a CSR for a period sufficient to cover 25 customer calls. Two of these calls were Home Services' calls for which the customer had incorrectly made one of the "utility" selections above. In order to ensure that the call categorization process did not miscount these calls as "utility" for cost allocation purposes, it was necessary for the CSR to reroute the calls, which was done for the two misrouted calls that occurred during our observation.

¹⁴ The fact that this can occur is not intended to suggest it does occur as a matter of practice.

¹⁵ In other words, CSRs would be required to sign out of the appliance services' database and sign on to the utility database. In our view, this would not seriously affect NJR's ability to extract economies of scale.

the policy address competitive gas commodity sales (a service that was, but is no longer, provided by NJR Natural Energy). Concerning the policy's application to appliance services, we noted the following:

- C Although NJNG's non-discrimination policy states that NJNG will not share non-public customer usage information with a Retail Affiliate, there is nothing in the CSR guideline that addresses the subject of CSRs accessing gas utility account information when working a Home Services' call. As noted above, there are also no system controls to prevent this.
- C An item entitled "No Heat Calls" contains the following instruction: "Do transfer a "no heat" call to NJR Home Services during October 1 through May 31 of each year, if by talking to the customer, you are able to determine that the customer has no heat because there is a problem with an appliance and not with the customer's utility service." In the 2001 Compliance Plan, this item contains the parenthetical "By Special Permission of the BPU". In the 2002 Compliance Plan the parenthetical has been changed to "Pending Approval by the BPU".¹⁶

At a minimum, the CSR policy should be amended to include instructions prohibiting the use of gas utility information in providing customer inquiry services to appliance customers. With regard to "no heat" calls, should the BPU approve NJNG's request to transfer these calls to Home Services, it should be noted that this could significantly enhance the competitive advantage Home Services already derives from its affiliation with the utility relative to smaller competitors.

3. CSR Appliance Services Incentive Payments

Prior to 2001, NJR had a policy of paying commissions to CSRs for signing up new appliance services contract customers. NJR represents that it no longer pays CSRs to promote appliance services.

G. Appliance Service Profitability, Pricing and Cross-Subsidization

1. Profitability Measured By Accounting Statements

A fundamental test of whether NJR or NJNG are subsidizing Home Services is if Home Services' prices are high enough to recover fully-allocated cost (i.e., whether Home Services makes a profit). In 2001, Home Services made \$404,000 from operations (before taxes) on revenues of \$12,964,000. In 2002, Home Services operating income before tax was \$1,447,000 on revenues of \$17,241,000.

Included in Home Services' costs are allocations of shared utility, service company and corporate costs. Many of these appeared to be based on attributable cost allocation methods; however, in some cases we were unable during the audit to obtain sufficient support for some common cost allocations to determine that Home Services is recording a proper share of these costs and in at least two cases (collections and customer inquiry) at least some of the costs

¹⁶ In response to a draft of the audit report, NJR provided a draft of a revised CSR "Do's and Don't's" policy showing the removal of the instruction to transfer no heat calls to Home Services.

attributable to Home Services were not properly allocated by NJNG. To the extent common cost allocations are not grossly understated (something that appears unlikely), Home Services' profit margin indicates that its prices are probably sufficient to cover its fully allocated cost. Thus, Home Services' prices appear high enough that they are not cross-subsidized. However, to the extent that NJR or NJNG allocated common costs to NJNG that should have been allocated to Home Services, NJNG has cross-subsidized certain Home Services costs. For example, NJNG was charged for Home Services' share of the costs of running the computer that housed Home Services' customer accounts. This reflects a cross-subsidy of Home Services costs by NJNG.

2. Going Concern Value Transferred by NJNG to Home Services

When Home Services began operations in 2001, NJNG transferred a service contract customer list and associated cash flow to Home Services. The customer list and associated cash flow, built up by the gas utility over a number of years, reflected the essential going concern (economic) value of the utility's appliance service business. If NJNG had sold the business to an unaffiliated third party, it would have received compensation for this value. Value would have been measured on a discounted cash flow basis and would likely have been in the millions of dollars.¹⁷

Under a BPU Stipulation, NJNG ratepayers were credited for an amount of approximately \$500,000 over three years based on decreasing percentages of Home Services' margin. While this might be considered compensation for going concern value, it is not so specified in the Stipulation and there is no support for the notion that the amount fully recovers the value of the business at the time of the transfer. Currently, through Home Services' ongoing affiliation with NJNG and its brand, business value continues to flow from NJNG to Home Services, although compensation required by the Stipulation has ended.

We did not include going concern value or the value derived from utility brand affiliation in drawing conclusions about cross-subsidization. It is within reason to argue that the lack of compensation or under-compensation in transferring the business and brand value transferred from NJNG to Home Services amounts to a significant economic cross-subsidy. However, it is equally important to point out that there is nothing in the Affiliate Standards that requires holding companies or their competitive services affiliates to compensate utilities for the transfer of competitive services' going concern or brand value.

3. Analysis Home Services' Prices for Services

Because Home Services is no longer part of NJNG, its prices are not subject to tariff or the floor price rules of the Affiliate Standards. We analyzed the potential for cross-subsidization in terms of individual service categories as follows:

- a. Appliance Service Contracts - Approximately [redacted] of Home Services' revenue comes from appliance service contracts. Because Home Services "makes money" it appears that Home Services' contract prices are sufficient to cover its costs of inspecting and maintaining contracted appliances.

¹⁷ However, it is important to point out that the value to a third party would be significantly lower if it excluded an ongoing partnership or affiliation with the utility and use of associated brands.

- b. Discounted Service Contracts - Home Services was offering two discounts on its website at the time of our review: a 10 percent multi-appliance discount (10 percent discount on the contract if two or more appliances are covered) and a 10 percent senior discount. The setup cost of an appliance service visit (mainly, the fully loaded cost of taking the service order and driving to the customer's home) easily justifies a 10 percent discount for additional appliances. However, because operating margins overall are slim, and because there appears to be no cost advantage to supplying appliance service contracts to older people (indeed, they may present a cost disadvantage if they tend to have older and more breakdown-prone appliances), it is possible that the discounted appliance contract prices provided to seniors fall slightly below the fully distributed cost of providing the service. Because Home Services makes money overall, this cross-subsidy, if it exists, is between Home Services' own customer groups (flowing from the general service contract customer to the senior citizen customer). These generational subsidies are common throughout the economy and are not considered to be anti-competitive.
- c. Special Offers - Home Services currently has two "special offers" running in conjunction with new appliance installations: one provides for a free one-year service contract and a free programmable thermostat. The other provides for a 20 percent discount for new service contract customers signing up for two or more appliances. Depending on whether the cost of the "free" contract is embedded in the installation price, it is possible that the first special offer may reflect a short run cross-subsidy of those installation customers by other Home Services' contract customers. However, since the service contracts are attached to new appliances, in the long run these customers should more than make up for their first "free" year with contract payments exceeding Home Services' maintenance costs in subsequent years, assuming a sufficient percentage of them remain contract customers after the first year. This does not appear to present a significant cross-subsidy issue. The second special offer discount represents an enhancement of the multi-appliance discount available to all customers. The cross-subsidy issue is minor and is the same as that discussed for seniors in the paragraph above.
- d. Prices for "Chargeable" Jobs - A small portion (about 10 percent) of Home Services' revenue comes from "chargeables". Chargeables include the repair and maintenance of appliances not under contract. The time-based prices currently posted on Home Services' website are:
1. \$75 / \$112.50 regular and off-hours, first 30 minutes on-site
 2. \$35 / \$52.50 per additional 15-minute increment
 3. \$27 / \$40.50 per additional appliance per 15-minute increment, same visit

To test whether these rates cover fully distributed cost, it is necessary to estimate Home Services' fully distributed cost per productive hour for comparison to the chargeable rate. A productive hour includes time on the job, excluding drive time (which must be excluded for comparison if it is not separately charged). An estimate of Home Services' fully distributed cost per productive hour, based on conservative assumptions, is shown below:

Table 4-5 NJR Home Services Estimated Fully Distributed Cost of Appliance Services		
	2001 Amount	2002 Amount
HS total operating costs, including corporate allocations, before income tax (per HS financial statements - OC-14)	Redacted	Redacted
Less: Cost of parts (1)	Redacted	Redacted
HS total operating costs, less cost of parts	Redacted	Redacted
Estimated average "hands on" HS employees, 2001 (per analysis of HS employee list - OC-24)	Redacted	Redacted
Estimated average weeks on the job per employee (assumes avg 4 weeks for vacation, sick and holiday)	Redacted	Redacted
Days per week	Redacted	Redacted
Estimated productive hours per day per employee (assumes an average of 2 1/2 hours per day for breaks, drive time, training)	Redacted	Redacted
Estimated HS annual productive on-site service hours, 2001 (line 4 x 5 x 6 x 7)	Redacted	Redacted
HS Estimated FDC per productive hour, including cost of parts (line 1 div. by 8)	Redacted	Redacted
HS Estimated FDC per productive hour, excluding cost of parts (line 3 div. by 8)	Redacted	Redacted
Notes: 1. The cost of parts for 2002 was gathered from the HS financial statements (OC-14). No parts information was presented on the 2001 HS financial statements. The 2001 amount is an estimate based on the 2002 amount. The ratio of parts cost to total operating costs for 2002 equals approximately [redacted]. [Redacted]		

The "cheapest" unit of chargeable time is the \$75 for the first 30 minute time on-site increment, because it reflects 30 minutes of on-site time and associated drive time. Assuming 1) accurate billing practices, 2) average drive time of 15 minutes, and 3) an average time-on-site of between 20 and 25 minutes (for jobs that do not kick into the next billing increment), Home Services is recovering approximately \$120 per hour for the first \$75 "chargeables" increment. Additional 15 minute increments, priced at \$35, equate to hourly rates of \$140. Overall, these rates come close to our estimate of fully allocated hourly cost for 2001 and 2002.

H. Analysis of Home Services' Competitive Advantages and Disadvantages

1. Competitive Advantages

- a. Utility brand affiliation - Home Services' affiliation with the gas utility, directly promoted through advertising, provides it with a clear competitive advantage over smaller, lesser-known appliance service providers. Being associated with the utility is likely to inspire a higher degree of customer trust in Home Services and the employees it sends into customers' homes. Apart from the higher level of trust that utility association inspires,

the names New Jersey Resources, NJR and New Jersey Natural Gas have name recognition value. It is not unreasonable to expect that those living in NJNG's service territory recognize the gas utility's name. The same cannot necessarily be said for smaller companies participating in the appliance services market. However, larger, nationally recognized retailers providing appliance services may have similar brand recognition and, with some customers their brand may be more recognized than the utility's.

- b. Economies of scale - The size of NJNG's service territory, encompassing several hundred thousand potential customers, provides it the ability to extract economies of scale that competitors with smaller geographic footprints cannot attain. However, larger retailers may have similar economies of scale.
- c. Access to the utility's customer service, billing and dispatch functions and information system - The ability to tap into a fully staffed utility customer care function and an established customer service information system is also a competitive advantage. When gas appliance owners have problems with heat (either their furnace or their water heater), they may make the gas utility their first call. When they do, NJNG's call router presents a series of options, some of which turn the call over to Home Services. Competitors do not enjoy similar placement as a selection option on NJNG's call router. With respect to the cost of conducting customer operations, although Home Services pays a usage-based share of most customer service costs, it did not have to pay any of the costs to develop the customer service function or the customer service information system.¹⁸ For several reasons, including a lack of scale economies, a smaller competitor would in most cases find a similar customer service information system and function to be more expensive, if not unaffordable.

2. Competitive Disadvantages

- a. Utility affiliation - There are individuals who resent utilities because of their monopoly status or because they have had bad experiences with the utility company. For these individuals, Home Services' affiliation with NJNG could represent a competitive disadvantage in some cases. On balance, we believe the advantages of utility affiliation outweigh the disadvantages.
- b. Corporate overheads and shared administrative services costs - Home Services incurs allocations of corporate administrative expenses that smaller competitors may not incur. Smaller competitors are unlikely to incur costs similar to those incurred by executive, treasury, investor relations and legal functions. We estimate the corporate amounts that could be avoided by disengaging from NJR are outweighed by the scale economies Home Services attains from shared use of the utility's billing, customer inquiry, dispatch and transportation maintenance functions.

¹⁸ As a new separate business unit beginning in 2000, Appliance Services was able to piggyback onto a fully-developed customer service function and information system. In addition, we found that Home Services does not pay a share of the cost of maintaining its accounts on the AS-400 computer, which holds both NJNG's and Home Services' customer data. As explained elsewhere, this is a cross-subsidy of Home Services by NJNG.

Chapter 5 -NJR's Energy Affilliates

Chapter 5 - NJR's Energy Affiliates

I. Introduction

This chapter covers the relationships and transactions between New Jersey Natural Gas (NJNG) and its non-utility energy affiliates, NJR Energy Services Company (Energy Services), NJR Natural Energy (Natural Energy) and NJR Energy Holdings (Energy Holdings). Energy Services provides unregulated wholesale energy services that include gas supply, pipeline capacity supply and gas storage services. Energy Services shares certain employees with NJNG. For a brief period, Natural Energy was in the business of marketing gas to retail customers. Natural Energy is currently inactive and has no employees. Energy Holdings is an investment holding company. Currently, its primary investments include relatively small stakes in Iroquois Gas Transmission System, a Federal Energy Regulatory Commission (FERC)-regulated gas transmission line and one of the pipelines supplying NJNG, and Capstone Turbine, a microturbine company. As a holding company, Energy Holdings has no employees or active operations.

II. Summary of Audit Findings

- A. NJNG Separation from Energy Services** - As a wholesale energy subsidiary, Energy Services is not subject to the BPU's Affiliate Standards. Nevertheless, during the audit period, NJR created a separate department for Energy Services and transferred some NJNG employees to it. NJR maintains appropriate accounting separations between NJNG and Energy Services. Although separate for payroll purposes, NJNG and Energy Services are not well separated from a management or functional standpoint. Energy Services continues to share management, supervision, some technical functions, physical space and information systems with the gas utility.
- B. Energy Services Sales to NJNG** - The functional and management inter-relationships between NJNG and Energy Services may create conflicts of interest if NJNG and Energy Services are on both sides of the same gas supply transactions. However, Energy Services represents that it does not sell gas or pipeline capacity to NJNG.
- C. NJNG Services to Energy Services** - Energy department employees providing services to both NJNG and Energy Services are maintained on NJNG's books for payroll purposes. These employees track time spent on wholesale activities on timesheets. Functions such as gas supply analysis and transportation nominating and balancing provided by NJNG to Energy Services account for approximately \$500,000 annually of inter-company revenue to the utility.
- D. Stagecoach** - In 2001, Energy Services entered into a contract to market storage in the newly-developed Stagecoach field owned by Central New York Oil & Gas and its parent, eCorp Holdings, LLC. In 2002, NJNG bid for and purchased storage in Stagecoach. We were not able in the time available to conduct a detailed examination of the technical and management issues surrounding this transaction in sufficient depth to determine whether NJNG's purchase decision was reasonable. Nothing came to our attention to indicate that NJNG did not have a legitimate basis for acquiring the storage or that the transaction was otherwise unreasonable. However, the potential for conflict of interest,

due to the management and functional inter-relationships between NJNG and Energy Services, may warrant a more detailed analysis of the transaction.

- E. **Retail Energy Services** - During the audit period, NJR moth-balled its retail gas sales organization, NJR Natural Energy. By 2002, Natural Energy was essentially inactive. NJR indicated it has no current plans to offer the gas commodity to customers in NJNG's service territory through an affiliate. As such, the separation, marketing and cross-subsidization concerns relating to retail energy competition do not currently apply to Natural Energy. However, the importance of these issues will re-emerge should Natural Energy resume operation.

III. **Audit Analysis**

A. **Operations and Financial Summary**

1. **NJR Energy Services (Wholesale)**

Energy Services was established in 1996. It sells and trades natural gas and gas pipeline capacity in the wholesale market and manages natural gas storage. Among the ways Energy Services makes money is by buying gas from various suppliers, aggregating it, adding transportation purchased from pipelines and reselling it as a bundled product. By bundling and aggregating, something the interstate pipelines are not allowed to do, Energy Services adds value to the piece-parts, creating an opportunity for margin.¹ Energy Services customers include utilities and other gas marketers.

NJR's employee lists suggest that Energy Services was operated by the employees of NJNG's (regulated) Energy Service department until 2001. NJNG is responsible for obtaining its own gas and gas transportation. In supplying gas to NJNG's utility customers, NJNG's Energy Services department performs many of the same functions required to run the wholesale subsidiary. NJR Energy Services (the affiliate) established its own department within NJR in 2001; however, as discussed below, there remains significant inter-relationships between the wholesale and utility energy supply functions.

The following table summarizes Energy Services' (the affiliate's) 2001 and 2002 financial results.

¹ Interview notes, Joe Shields, October 30, 2002.

Table 5-1 NJR Energy Services (Wholesale Energy Sales) Summarized Results of Operations		
	Amounts in 000s	
	2001	2002
Operating Revenue	Redacted	Redacted
Cost of Gas	Redacted	Redacted
Operating Margin	Redacted	Redacted
O&M Expense & General Taxes	Redacted	Redacted
Other Income (Expense)	Redacted	Redacted
Income (Loss) Before Income Tax	Redacted	Redacted
Income Tax	Redacted	Redacted
Effect of Account Change, Net	Redacted	Redacted
Net Income (Loss)	Redacted	Redacted
Source: OC-65		

2. NJR Natural Energy (Retail)

Natural Energy was established in 1995 to sell gas in the retail market (to end users). At the end of fiscal year 2000, Natural Energy had approximately 13,000 residential retail customers and 11 interruptible customers. By this time, Natural Energy had already sold its commercial retail contracts to a third party and was getting ready to exit the gas commodity marketing business. In fiscal year 2001, Natural Energy had its own department with one employee. By fiscal year 2002, Natural Energy was inactive. NJR indicated that it no longer intends to sell retail gas. The table below summarizes Natural Energy's financial results for 2001 and 2002.

Table 5-2 NJR Natural Energy (Non-Reg Retail Energy Sales) Summarized Results of Operations		
	Amounts in 000s	
	2001	2002 (1)
Operating Revenue	\$ 5,677	\$ -
Cost of Gas	5,718	-
Operating Margin	(41)	-
O&M Expense & General Taxes	602	(12)
Depreciation & Amortization		-
Other Income (Expense)	219	19
Income (Loss) Before Income Tax	(383)	31
Income Tax	(134)	11
Net Income (Loss)	\$ (249)	\$ 20
Notes:		
1. Amounts are 10 months ended July 31, 2002.		
Source: OC-65		

3. NJR Energy Holdings (Investments)

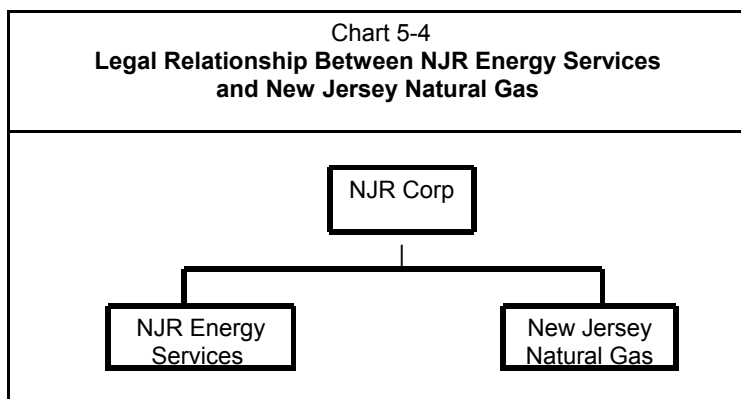
Energy Holdings does not have operations or employees. Prior to 1997, its subsidiary, NJR Energy Corp was involved in oil and gas development, production, transportation and storage ventures. NJR exited these businesses in 1996. Today, Energy Holdings consists of subsidiaries NJR Energy Corp and NJR Pipeline. The subsidiaries own equity investments in the Iroquois Gas Transmission System (Iroquois), a FERC-regulated interstate gas pipeline running from Canada to Long Island, and Capstone Turbine (Capstone), a microturbine developer. NJNG is a customer of Iroquois. The table below summarizes Energy Holding's financial results for 2001 and 2002.

Table 5-3 NJR Energy Holdings (Energy Investment Company) Summarized Results of Operations		
	Amounts in 000s	
	2001	2002 (1)
Operating Revenue	\$362	\$130
O&M Expense & General Taxes	244	477
Other Expense (Income)	(1,098)	(751)
Income (Loss) Before Income Tax	1,217	404
Income Tax	432	98
Effect of Accounting Change, Net	(384)	-
Net Income (Loss)	\$401	\$306
Notes:		
1. Consolidated financials not provided. Figures reflect additive results of NJR Energy (Capstone) and NJR Pipeline (Iroquois) before consolidating entries.		
Source: OC-65		

B. Organizations

1. Energy Services (Wholesale) Organization

- a. Energy Services Legal Organization - The chart below summarizes the legal relationship between NJNG and Energy Services (the affiliate).



- b. Energy Services Functional Organization - We were unable to find employees for a separate Energy Services affiliate department on the 2000 NJR employee listing.² In 2001, the employee list showed NJR established department 7000, officially named "Payroll Dept - NJRES", with 6 employees. By 2002, Energy Services had 13 employees, two of whom had transferred from the gas utility's Energy Services department (department 410).³ The wholesale affiliate Energy Services and NJNG's department 410 perform similar gas supply functions and are managed by the same individual, Joseph Shields. Mr. Shields, Senior Vice President of Energy Services, works for both the wholesale subsidiary and the gas utility's department. The table below summarizes the combined NJNG and NJR wholesale organization as of August, 2002.

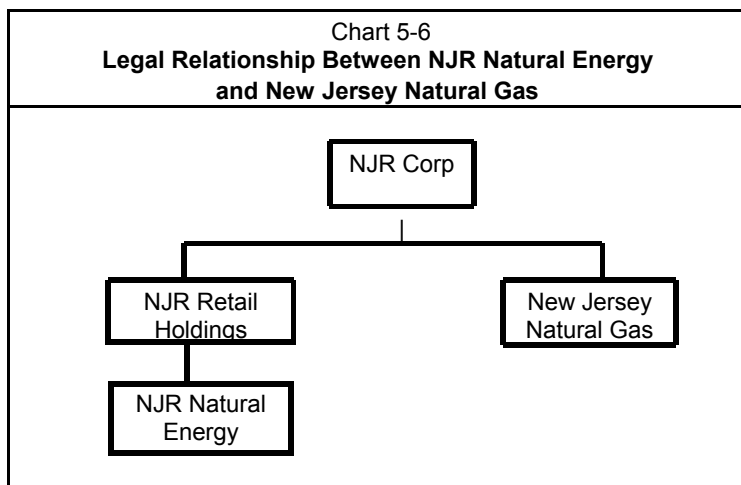
² OC-24.

³ Hereafter we refer to the utility's Energy Services department by its department number, 410, to avoid confusion with NJR's wholesale Energy Services subsidiary.

Table 5-5				
NJNG Energy Services and NJR Energy Services Payroll Organizations - Fiscal Year 2002				
Department		Job Description	Name	
<u>New Jersey Natural Gas Energy Services</u>				
410	Energy Services	SVP - Energy Services	Joseph	Shields
410	Energy Services	Manager - Gas Control	Eugene	Conkling, Jr
410	Energy Services	Load Dispatcher	Roger	Brzozowski
410	Energy Services	Load Dispatcher	Gail	Hammil
410	Energy Services	Load Dispatcher	Wayne	Kaczorowski
410	Energy Services	Load Dispatcher	Susan	Keegan
410	Energy Services	Load Dispatcher	John	Schultz
410	Energy Services	Admin. Asst. II	Linda	Bracken
410	Energy Services	Sr. Trader	Gerald	Barth
410	Energy Services	Engineer III	Cynthia	Stavrou
410	Energy Services	Supv-Gas Control	Saverio	Vasto, Jr.
410	Energy Services	Senior Gas Supply Analyst	Robin	Ryan
410	Energy Services	Senior Gas Supply Analyst	Deborah	Wyckoff
410	Energy Services	Gas Supply Analyst II	Douglas	Rudd
410	Energy Services	Gas Supply Analyst II	Rose	Becker
410	Energy Services	Gas Supply Analyst II	Barbra	Zetterlund
410	Energy Services	Gas Supply Analyst II	Stephen	Greene
410	Energy Services	Supervisor - Trans & Exch.	Kathryn	Ferreira
410	Energy Services	Supv-Gas Economics	Thomas	Klaus
410	Energy Services	Trans & Exchg. Anal.	Craig	Halleck
410	NJNG Energy Services Count		20	
<u>NJR Energy Services (Wholesale Affiliate)</u>				
7000	Payroll - NJRES	Dir-Ener. Svcs.	Richard	Gardner
7000	Payroll - NJRES	Dir.Capacity Mgnt, Gas Supply	Stephen	Westhoven
7000	Payroll - NJRES	Clerical Asst. II	Kathleen	Casey
7000	Payroll - NJRES	Wholesale Gas Marketer	Sean	Annitto
7000	Payroll - NJRES	Energy Trader	Timothy	Shea
7000	Payroll - NJRES	Energy Trader	David	Johnson
7000	Payroll - NJRES	Gas Supply Analyst II	Dean	Tierney
7000	Payroll - NJRES	Contracts Mgr.	Adrienne	Kalbacher
7000	Payroll - NJRES	Wholesale Analyst	Dennis	Veltre
7000	Payroll - NJRES	Asset Analyst	Amy	Winans
7000	Payroll - NJRES	Trans. & Exchg. Anal.	Anthony	Rose
7000	Payroll - NJRES	Trans. & Exchg. Anal.	Juan	Tehume
7000	Payroll - NJRES	Trans. & Exchg. Anal.	Steven	Harper
7000	Payroll Dept - NJRES Count		13	

2. Natural Energy (Retail) Organization

- a. Retail Energy Legal Organization - The legal relationship between Natural Energy and NJNG is shown below.

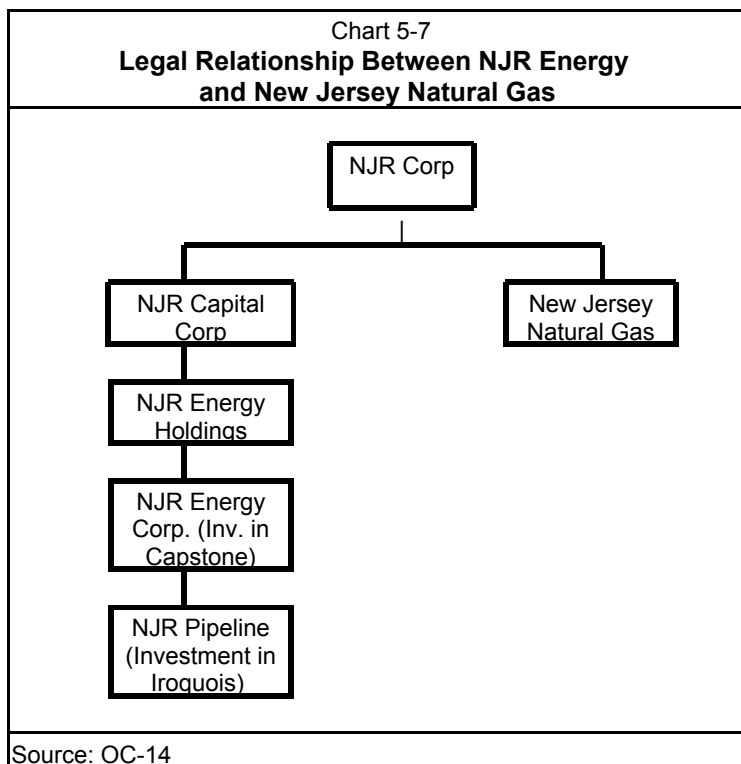


- b. Retail Energy Functional Organization - We were unable to identify any Natural Energy employees on the NJR 2000 employee list. However, it appears from Natural Energy's income statement that it had several "support" employees who accounted for approximately \$250,000 in salaries. These employees may have been gas utility employees for payroll purposes and been charged exclusively to Natural Energy, or they may have been excluded from the 2000 employee list we reviewed. NJR's 2001 employee list shows that Natural Energy had one employee, Rhonda Figueroa, Manager of Marketing Services.⁴ By fiscal year 2002, Natural Energy was inactive and Ms. Figueroa had been transferred to NJR Home Services' Customer Services department.

3. NJR Energy Holdings (Investment) Organization

NJR Energy Holdings (Energy Holdings) currently maintains investments in Iroquois and Capstone through its subsidiaries, NJR Energy Corp and NJR Pipeline . Energy has no employees and essentially no functional operation. The legal relationship between Energy and NJNG is summarized below.

⁴ OC-24



C. Separation from the Utility

1. Functional and Management Separation

In the case of the retail subsidiary, Natural Energy, and the investment company, Energy Holdings, separation from the utility is not currently a concern because neither subsidiary has operations that interact with NJNG. Although NJNG is a customer of Iroquois, an Energy Holding investment, NJR's 3.3 percent stake in Iroquois is small enough that it should not raise significant concern about NJNG's customer relationship.

Although it now has a separate department designation, Energy Services, the wholesale affiliate is not well separated from NJNG.⁵ There are significant functional inter-relationships between NJNG and Energy Services. Although divided for payroll purposes, Energy Services and NJNG's Energy Services department 410 are managed by the same executive (Joseph Shields, Senior Vice President, Energy Services) and share employees. Both departments conduct gas trading and transportation operations from the same space. Both share gas management and financial management information systems. NJNG employees working on activities relating to NJR Energy Services track affiliate time on timesheets.⁶ Examples include:

⁵ It is Overland's understanding that Energy Services is not subject to the BPU's Affiliate Standards.

⁶ Interview notes, Kathy Ferreira, December 12, 2002.

- C Supervisor, Transportation and Exchange - Works gas nominations on behalf of both NJNG and Energy Services, and tracks time for Energy Services on timesheets.⁷ This individual also supervises transmission and exchange analysts working for Energy Services on the wholesale side.⁸
- C Gas Supply Analysts (2) - Split time approximately 50 / 50 between NJNG and Energy Services based on timesheets.⁹
- C Transportation and Exchange Analyst - Primarily NJNG, but also performs services for Energy Services.¹⁰

Although the gas utility supplies services, including management and supervision, to Energy Services, NJR represents that the wholesale subsidiary does not currently provide services to NJNG.¹¹

2. Accounting Separation

All NJR energy subsidiaries maintain separate sets of books. There is no commingling of accounts with NJNG. However, the energy subsidiaries and NJNG share some corporate administrative functions and Energy Services shares some NJNG employees. Certain costs are allocated between NJNG and the NJR energy subsidiaries. Energy Services' executive Mr. Shields stated that Energy Services' asset portfolio (its supply of gas and gas capacity for resale) are maintained separately from NJNG's energy portfolio.

3. Asset Separation

NJNG does not currently share significant physical assets with the NJR energy subsidiaries. A review of NJR Energy Services balance sheet indicates that it owns \$1.5 million in furniture, fixtures and equipment. However, as noted above, Energy Services and NJNG share office space.

4. Information and Information Systems Separations

In addition to shared corporate accounting and administrative systems, it appears that NJNG and Energy Services directly share at least two energy systems: MOSI (Multi-Options Systems Integration), a gas management system, and Zainet, a financial risk management system. Both systems are maintained by NJR Service Company's Integrated Business Systems (IBS) department.

⁷ Ferreira interview notes.

⁸ Interview notes, Joseph Shields, October 30, 2002.

⁹ Interview notes, Alan Denninger, December 11, 2002.

¹⁰ Ibid.

¹¹ Ibid.

D. Marketing and Promotion

NJR's retail affiliate, Natural Energy, is currently inactive. There is little reason for cross-marketing and promotion between NJNG and Energy Services because of the unrelated nature of the markets each one serves. To the extent Natural Energy or some other subsidiary provides a competitive gas commodity service within NJNG's service territory, it will have a competitive advantage by virtue of its affiliation with the utility.

E. Transactions between NJR, NJR Service Corporation and the NJR Energy Subsidiaries

NJR and NJR Service Corporation allocate certain corporate and administrative costs to all subsidiaries. These are discussed in Chapter 3.

F. Transactions between NJNG and the NJR Energy Affiliates

1. Services provided by NJNG

The gas utility Energy Services department 410 accounted for the majority of services provided to non-utility energy subsidiaries during the audit period. As described above under the heading "Functional Separation", these services consisted primarily of management and supervision, gas supply analysis and transportation and exchange (nominating and balancing) services provided by NJNG employees to Energy Services. The table below summarizes NJNG cost allocations shown on energy subsidiary financial statements.

Table 5-8 NJNG Cost Allocations to NJR Energy Affiliates			
Year	Energy Holdings	Natural Energy	Energy Services
2000	\$ -	\$ 50,832	\$ 472,008
2001	-	5,797	474,123
2002	-	-	513,801
Source: OC-65			

2. Services provided by NJR Energy Services to NJNG

Energy Services represents that it does not sell gas, gas transportation or gas storage management services to NJNG.¹² In other words, NJNG is not a customer of Energy Services. Given the functional inter-relationships between NJNG and Energy Services and the common management of the two subsidiaries, any customer relationship between NJNG and the wholesale subsidiary would present a high potential for conflict of interest.

¹² Interview notes, Joseph Shields, October 30, 2002.

G. The Stagecoach Project

1. Energy Services Marketing Contract with eCorp Holdings

In 2002, Energy Services entered into a marketing agreement with eCorp Holdings, LLC (eCorp) to market gas storage in the newly-developed Stagecoach Storage Field (Stagecoach). Stagecoach is owned by eCorp through a subsidiary, Central New York Oil & Gas. Under the marketing agreement, Energy Services is the exclusive marketing agent for Stagecoach. Energy Services' contract provides eCorp with guaranteed annual storage revenues of at least \$22 million provided that storage and transportation are available. For a period of 10 years, should revenues fall short, eCorp has the right to compel Energy Services to take possession of storage to make up the shortfall. Presently, Energy Services estimates between \$18 and \$20 million of storage revenue has been contracted.¹³ Although Energy Services does not currently own any of the Stagecoach field, it has an option to purchase up to a 10 percent equity stake if eCorp sells the project.¹⁴

According to the contract between eCorp and Energy Services, Energy Services (as marketing agent) is to be compensated by eCorp beginning with the development phase of Stagecoach as follows:¹⁵

- C Out of pocket expenses associated with storage marketing activities, up to a limit (the limit is undisclosed in the copy of the contract provided to us).
- C A fee for "software and backroom tools" necessary to perform marketing services (amount undisclosed in the data response copy of the contract).
- C Revenue sharing incentive payments (amount undisclosed in the data response copy of the contract).
- C A monthly "fee" (amount undisclosed in the data response copy of the contract).
- C Payment for system infrastructure; in particular, payment for use of NJR's MOSI system software (amount undisclosed in the data response copy of the contract).

Although the compensation amounts were "starred out" in the copy of the contract provided to Overland, an Energy Services' accountant indicated his belief was that Energy Services' revenue-sharing incentive payments (the most important compensation component) consist of the following:

- C No incentive payment for the first \$ [redacted] in revenue,
- C [redacted] percent of revenue between \$ [redacted] and \$ [redacted] (\$[redacted]); and,

¹³ Interview notes, Alan Denninger, December 12, 2002.

¹⁴ Ibid.

¹⁵ OC-90.

C [redacted] percent of revenue over \$ [redacted]

Basically, the contract is structured so that Energy Services is at risk for annual storage revenues below \$ [redacted] , and has significant profit potential at revenue levels above \$[redacted] .

2. NJNG's Stagecoach Storage

NJNG was one of the companies that bid for and obtained storage at Stagecoach when it opened in 2002. Because NJR is on both sides of the transaction (with NJNG as buyer and Energy Services receiving commissions for marketing the storage), NJNG's purchase of Stagecoach storage represents a potential conflict of interest. The appearance of conflict exists in part because Mr. Shields is the primary executive managing both NJNG's Energy Services department and NJR's Energy Services' participation in Stagecoach. Following are the basic questions the transaction raises:

- C Does NJNG have a legitimate need for the storage it purchased from Stagecoach and is storage at Stagecoach the best of available alternatives given NJNG's present load characteristics and supply situation?
- C Did the risks and profit opportunities Energy Services has under its marketing agreement with eCorp influence the decision to have NJNG purchase storage?
- C What executives, other than Mr. Shields, played a role in deciding to have NJNG bid on the Stagecoach storage? Was Mr. Shields the primary advocate?

It is important to emphasize that these issues exist because of the structure of the relationship between NJNG and NJR Energy Services, not because of suspicions about the transaction arising during the audit. The issues that need to be thoroughly examined to draw a conclusion about the transaction include:

- C A technical assessment of NJNG's need for the storage and the benefits the storage might provide compared to other alternatives.
- C A review of NJR's decision to have NJNG bid on the storage, including the role played by Mr. Shields in the decision to purchase, and the risks NJR believed it faced under the eCorp marketing agreement at the time NJNG was considering a bid.

An additional issue concerns NJR's role in overseeing the bidding process. As marketing agent, Energy Services was responsible for posting information on electronic bulletin boards and managing the bid process. Based on review of documents and interviews, we are satisfied that information concerning Stagecoach availability and capacity, including information about capacity on the Tennessee lateral line serving the storage field, was properly posted on electronic bulletin boards.

Overland submitted data requests for the Energy Services' contract with eCorp, for Stagecoach requests for proposals and contracts with storage customers, and for justification of NJNG's need for the storage. Although the data we received was generally responsive, we determined

additional information is necessary to develop an objective, informed conclusion about the reasonableness of the transaction. We note from one of the data responses that the BPU and the Ratepayer Advocate's office looked at the Stagecoach transaction in 2002.

In summary:

1. Functional and management inter-relationships between NJNG and Energy Services create a potential conflict of interest between Energy Services, as marketing agent for Stagecoach, and NJNG, as a customer of Stagecoach.
2. The price NJNG is paying for the Stagecoach storage on which it bid appears to be the result of an open bidding process.
3. Nothing came to our attention during the audit to indicate that NJNG did not have a legitimate reason for acquiring storage at Stagecoach. However, we do not have sufficient information regarding decision-making and technical complexities to reach an objective conclusion about the reasonableness of this transaction.

H. Employee Transfers

Review of employee lists showed that NJNG transferred the following employees to Energy Services between fiscal year 2001 and the end of fiscal year 2002:

- C Richard Gardner, Director - Energy Services
- C Dean Tierney, Gas Supply Analyst II
- C Steven Harper, Transportation and Exchange Analyst

NJR's policy is to list employee transfers between NJNG and a retail affiliate on its website. It is also NJNG's stated policy to comply with Affiliate Standards restrictions on transfers between the utility and a retail affiliate. It does not appear that NJNG considers Energy Services to be a "retail" affiliate; therefore, compliance with Affiliate Standards restrictions is presumably inapplicable for the employees listed above; in other words, they may be transferred between NJNG and Energy Services at any time and for any reason. It is likely that these transfers improved the separation of functions between the gas utility and wholesale affiliate.

Appendix 1 - Interview List

New Jersey Resources Corporation Interview List			
Date	Interviewee	Interviewer	Subject/Topic
9/9/2002	Tim Hearne	Bob Welchlin/Andrew Miller	Accounting Overview
9/10/2002	Jason Solimini/Joe Kruszewski/ Brain Fitzpatrick/Dan Reganata	Bob Welchlin/Andrew Miller	Affiliate Accounting
9/11/2002	Joe Kruszewski	Bob Welchlin/Andrew Miller	NJR Service Company and NJNG Allocations
9/13/2002	Tom Massaro/Lester Davis	Bob Welchlin/Andrew Miller	NJR Home Services
10/02/02	Joe Kruszewski/John Lishak	Bob Welchlin/Andrew Miller	CR&R and Facilities Costs
10/03/02	Barbara Roma/Jim Hallock	Bob Welchlin/Andrew Miller	Customer Service Department
10/03/02	Debbie Zilai/Kevin Fornino	Bob Welchlin/Andrew Miller	Integrated Business Services (Information Technology)
10/29/02	Suzanne Bostwick/Sandy Davis/ Linda Parretott	Andrew Miller	Customer Service Call Center
10/30/02	Joe Shields/Kevin Moss	Bob Welchlin/Andrew Miller	Energy Affiliates and Gas Supply
12/10/02	Wayne Tarney/Roy Churchman	Bob Welchlin	NJR Home Services
12/11/2002	Alan Denninger	Bob Welchlin	
12/11/2002	Tim Hearne	Bob Welchlin	NJNG Capital, NJR Investment Co., NJR Pipeline Co., and Parent / Utility Financial Issues
12/12/2002	Alan Denninger/Cathy Ferreira	Bob Welchlin	Stagecoach Bid and Contracts
12/12/2002	Lawrence Downes	Bob Welchlin	Preliminary Audit Findings
12/12/2002	Tom Kochenash	Bob Welchlin	Home Services Award as Contractor for the Propane Conversion Program

Appendix 2 - Data Log

**New Jersey Natural Gas
DATA LOG OF OVERLAND CONSULTING
ON BEHALF OF THE NEW JERSEY BPU**

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 1	7/30/02	9/23/02	<p>Fin Data / Chart of Accounts</p> <p>Please provide a copy of New Jersey Natural Gas' and New Jersey Resources' current chart of accounts and accounting codes. Include keys to the Company's account coding block and all financial and management codes used to classify costs as to type, source, and departmental responsibility. Please also provide any previous versions of the chart of accounts that were in effect at any point since January 2000. If possible, please provide this information in electronic form.</p> <p><i>9/6/02--Partial--Received in hard copy format: 1) New Jersey Resources' Service Company dept. list, 2) explanation of NJNG account structure (code), 3) NJR subsidiary source codes, 4) NJNG dept. list, and 5) New Jersey Resources' Service Company chart of accounts; did not receive charts of accounts for NJNG or NJR or dept. list for NJR (Company stated in response that the charts of accounts would be made available to us on-site in on-line format) 9/6/02--Received in electronic format [Excel] additional charts of accounts, including one for NJR. Still have not received a chart of accounts for NJNG or dept. lists for NJR or affiliates other than Service Company and NJNG. 9/23/02--Complete--Received an explanation that affiliates other than NJNG, NJR Services, NJR Home Services, and NJR Plumbing Services do not use dept. codes.</i></p>	55

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 2	7/30/02	9/11/02	Policies and Procedures / Accting Procedures List Please provide copies of the following accounting procedures effective during the period 2000 through the present: 1. New Jersey Resources corporate cost allocation procedures describing allocation methodologies, cost pools, allocation factors and the use of allocation vs. direct assignment. 2. Timekeeping procedures used by employees performing competitive services and employees whose costs are charged to other subsidiaries (e.g. holding company employees). 3. Transfer pricing procedures applicable to pricing of inter-company services. 4. Fully distributed cost procedures applicable to pricing of competitive services. <i>9/6/02--Complete pending review--Received a memo describing cost allocation methodologies, timekeeping, transfer pricing, etc.; more detail may be needed and could be gathered with interviews and/or additional data requests; 9/11/02--Complete--Received a more complete memo and allocation methodology overview during an interview with Joe Kruszewski.</i>	43
C	OC 3	7/30/02	10/2/02	Policies and Procedures / Accting Procedures List Please provide a listing or index of all New Jersey Resources and New Jersey Natural Gas written accounting policies and standard practices in effect during the period January, 2000 to present. <i>10/2/02--Complete--Received a list of NJR accounting "procedures".</i>	64
C	OC 4	7/30/02	10/1/02	Regulatory / BPU Filings Please provide a copy of New Jersey Natural Gas' New Jersey BPU filings, in electronic format if possible, for 2000 thru 2002. <i>10/1/02--Complete--Received a list of NGNJ's BPU filings for fiscal years 2000 through 2002 to date.</i>	63
C	OC 5	7/30/02	9/3/02	Prior Audit / Implementation Plans Please provide copies of any implementation plans related to recommendations from the prior compliance audit done by Schumaker & Co. <i>9/3/02--Complete--Received a summary sheet documenting the implementation status of Schumaker & Co. recommendations. The majority of the recommendations were either eliminated per the BPU or addressed in the Company's Compliance Plan filed 6/15/01 with the BPU. NJNG included a copy of its Compliance Plans (for 2001 and 2002) as a part of its response to OC-14.</i>	35

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC6	7/30/02	9/11/02	Fin Data / Budgets Please provide a chart that shows the roll up of New Jersey Natural Gas and other New Jersey Resources subsidiary department budget responsibility centers through the management structure (e.g. managers, directors, vice presidents, CEO). Include the title of each responsibility center as of January 2001, January 2002, and current. <i>9/6/02--Non-responsive--Response refers to response to OC-13; the response to OC-13 does not provide the needed detail for this data request. 9/11/02--Complete--PDW accounting personnel, due to the small size of the Company, no "roll up" chart that links employees to responsibility centers exists. See OC-1 for department (business unit) lists for the Company's affiliates and OC-24 for employee lists by affiliate.</i>	43
C	OC7	7/30/02	9/6/02	Cost Allocations / Corporate Allocation Data For fiscal years 2000, 2001, and 2002 to date, please provide, in electronic spreadsheet form if possible, the New Jersey Resources corporate cost allocation model showing allocations among subsidiaries and underlying allocation formulas. <i>2/26/03--Update--After discussions with NJR indicated all cost allocation support was provided, Overland discovered that a complete audit trail was not in place. After additional follow-up discussions, NJR submitted new cost allocation support in an effort to provide a complete audit trail to support its allocation. The new material is still under review. 9/6/02--Complete--Received corporate cost allocation models in electronic format [Excel] for 2000, 2001, and 2002. 10/3/02--Received supplemental data (source documentation) related to the Company's cost allocations.</i>	38
C	OC8	7/30/02	9/6/02	Regulatory / FERC Filings Please provide a copy of New Jersey Natural Gas' FERC filings, in electronic format if possible, for 2000 through 2002. <i>9/6/02--Complete--Received the 2000 and 2001 (year-ended 12/31) FERC Form 2 Filings in hard copy format. The 2002 Filing will not be made until March, 2003.</i>	38
C	OC9	7/30/02	12/5/02	Affiliate / List of Competitive Services For fiscal years 2001 and 2002, please provide a list of all products and services, (other than regulated, tariffed, utility services) provided by New Jersey Resources subsidiaries to third parties. For each service, please indicate whether New Jersey Resources / New Jersey Natural Gas classifies the service or product as "competitive" under the BPU's Energy Competition Standards, Subchapter 5, Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements. <i>Complete. One page list identifying "appliance service" and "[appliance] service contracts" as competitive, real estate development and wholesale gas transactions as non-competitive.</i>	128

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 10	7/30/02	12/30/02	<p>Affiliate / Service Descriptions</p> <p>For each affiliate transacting business with New Jersey Natural Gas in fiscal years 2001 and 2002, please provide a list of the products and services provided:</p> <ol style="list-style-type: none"> 1. By New Jersey Natural Gas to affiliates 2. By affiliates to New Jersey Natural Gas. <p>Please include a brief description of each product or service to the extent it is not self-explanatory.</p> <p><i>12/30/02--Complete--Received a listing of services provided by NJR affiliates to other NJR affiliates. (NJNG to affiliates and affiliates to NJNG.) Consider complete.</i></p>	153
C	OC 11	7/30/02	9/11/02	<p>Affiliate / Intercompany Bills</p> <p>Please provide, in electronic format if available:</p> <ol style="list-style-type: none"> 1. A copy of all affiliate transaction invoices or statements for intra-company billings to and from New Jersey Natural Gas and affiliates for fiscal years 2001 and 2002. 2. Data used to develop or which supports the amounts on the invoices or statements. <p><i>9/11/02--Complete--Received a memo from Joe Kruszewski explaining that NJR does not utilize hard copy invoices and statements for intercompany billings. Intercompany charges are documented in the JDEdwards general ledger system. See OC-43 for copies of NJR's Intercompany Balance Monitoring Report.</i></p>	43
C	OC 12	7/30/02	9/23/02	<p>Affiliate / Intercompany Transaction Descriptions</p> <p>For fiscal years 2001 and 2002, please provide a list and brief description of inter-company transactions between New Jersey Natural Gas and its parent company or affiliates that do not involve the exchange of identifiable goods or services (e.g. financial transactions involving intercompany loans or dividends, management fees, tax allocation transactions, etc.)</p> <p><i>9/6/02--Partial--Response refers to the response to OC-14 in which the Company submitted its Compliance Plans. The Company refers to Exhibit I regarding "service agreements" between NJR, NJNG, and subs. The section does not clearly refer to any exchanges that do not involve identifiable goods or services such as financial transactions. Need a clear list and description of any such transactions. 9/23/02--Complete--Received a list of inter-company transactions that take place between NJR and NJNG, etc.</i></p>	55

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 13	7/30/02	9/12/02	Org Charts Please provide copies of management organization charts showing the job titles and New Jersey Resources subsidiary designations in effect for 2000 through present for the following units: New Jersey Resources Corporation New Jersey Natural Gas NJR Energy Services NJR Retail Holdings and subsidiaries <i>9/3/02--Partial--Received high-level current year (2002) organization charts for NJR Corporation, NJNG Company, NJR Retail Holdings (including NJR Home Services), NJR Power Services, NJR Unregulated Wholesale Energy Services, NJNG Officers, and NJNG Process Based Structure. No charts were provided for 2000 or 2001 and only certain charts provide more than a high-level view of the Company. 9/12/02--Complete--Received more detailed organizational charts for the entire Company as of 2002. No charts are available for 2000 and 2001.</i>	44
C	OC 14	7/30/02	9/6/02	Regulatory / BPU Compliance Plans Please provide copies of New Jersey Natural Gas' "compliance plans" for complying with BPU Energy Competition Standards in effect since the beginning of 2000. <i>9/3/02--Partial--Received the Company's 2001 and 2002 Compliance Plans filed with the BPU. The Company indicated that the 2000 Compliance Plan was also submitted but the Fedex package only contained the years mentioned above. 9/6/02--Complete--Received the Company's 2000 Compliance Plan.</i>	38
C	OC 15	7/30/02	9/11/02	Fin Data / Reports Please provide a list of recurring management and financial accounting reports available from the New Jersey Resources and New Jersey Natural Gas financial systems. <i>9/11/02--Complete--PDW Tim Hearne, a monthly packet of reports is produced each month. See Tim Hearne interview notes for a list of reports.</i>	43

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 16	7/30/02	10/15/02	<p>Org Charts</p> <p>Please provide copies of New Jersey Resources legal organization charts showing all subsidiaries and ownership relationships for the years 2000 through present. Please indicate the following for each subsidiary:</p> <ol style="list-style-type: none"> 1. whether consolidated into New Jersey Resources for accounting 2. percentage ownership 3. whether operating or non-operating 4. number of employees <p><i>9/6/02--Partial--Response refers to the response to OC-14 in which the Company submitted its Compliance Plans. The Company refers to Exhibit A regarding the "corporate structure" of NJR and its subsidiaries. The response answers parts 1, 2, and 3. The Company noted that it is currently compiling the information for part 4. 10/15/02--Complete--Received a listing showing the number of employees per affiliate.</i></p>	77
C	OC 17	7/30/02	12/5/02	<p>Affiliate / BPU Reporting</p> <p>Please provide, for the period January, 2000 to present, copies of the following records required by the BPU's Affiliate Relations, Fair Competition and Accounting Standards and Related Reporting Requirements:</p> <ol style="list-style-type: none"> 1. "Affiliate Discount Reports" that New Jersey Natural Gas has filed since January, 2000 (see 14:4-5.3 (g)) 2. Records of contracts and related bids between New Jersey Natural Gas and New Jersey Resources or competitive services affiliates. (see 14:4-5.4 (k)) 3. Reports of utility / affiliate employee transfers (see 14:4-5.5 (r) (2)) <p><i>12/5/02--Complete pending review--Received an answer to item 2 with supporting documentation. 12/05/02 - Remains incomplete. Answer to item 3 10/1/02--Partial--Received responses to parts 1 and 3 of the request.</i></p>	128

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 18	7/30/02	9/10/02	Affiliate / Financial Statements For the years 2000 and 2001, please provide financial statements for each New Jersey Resources affiliate that maintains separate books. <i>9/6/02--Partial--Received 2001 financial statements in hard copy format for 10 entities, including: NJR, NJNG, NJR Power Services, NJR Energy Services, NJR Home Services, NJR Plumbing Services, NJR Natural Energy, NJR Energy, NJNR Pipeline and New Jersey Natural Resources, NJR Investment Company, and Commercial Realty and Resources; 9/10/02--Complete--Received 2000 financial statements in hard copy format for 6 entities including NJR, NJNG, NJR Energy Services, NJR Natural Energy, NJNR Pipeline and New Jersey Natural Resources, and Commercial Realty and Resources; 9/11/02--Received 4 additional financial statements for 2002 (7/31/02) NJR Energy Services, NJR Home Services, NJR Plumbing Services, NJR Natural Energy</i>	42
C	OC 19	7/30/02	9/3/02	Affiliate / Separations & Information Procedures Please provide copies of any New Jersey Natural Gas, New Jersey Resources, or New Jersey Resources subsidiary written policies or procedures addressing the following subjects: 1. Joint corporate support services (utility and affiliate) 2. Joint use of computer systems and related controls to ensure separation of data access 3. Joint marketing, advertising, promotion services 4. Employee transfers and employee loans or sharing 5. Sharing / provision of utility non-customer, non-public proprietary data to affiliates 6. Sharing / provision of utility customer data to affiliates 7. Separation of utility and affiliate employees and board members 8. Procedures to be used by utility customer service and marketing personnel relating to provision of competitive services information to customers <i>9/3/02--Complete--Received the Company's 2001 and 2002 Compliance Plans which include exhibits providing NJNG's written policies for each of the areas requested. The Company provided a guide to match up exhibit numbers with the request numbers below.</i>	35

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 20	9/6/02	10/2/02	Fin Data / Trial Balances Please provide, in electronic format, business unit (dept.) level trial balances for all business units for fiscal years 2000, 2001 and 2002 (through the third quarter). Please update 2002 for the complete fiscal year when available. <i>9/23/02--Incomplete--Received the fiscal year 2001 and fiscal year 2002 trial balances to date (6/30/02) for NJR Service Company. Need trial balances for ALL affiliates for 2000, 2001, and 2002 to date. 9/26/02--Partial--Received additional trial balances; need to review to ensure all affiliates were received; still need NJNG, New Jersey Power Services, and New Jersey Natural Resources trial balances. 10/2/02--Consider complete--Received the NJNG trial balances for 2000, 2001, and 2002. Will review the New Jersey Power Services and New Jersey Natural Resources trial balance data with the Terminal/JDEdwards access provided by the Company.</i>	26
C	OC 21	9/6/02	10/28/02	Fin Data / Budget Variance Reports Please provide, for fiscal years 2000, 2001, and 2002 through July, copies of budget variance reports at the responsibility center level (subsidiary level) for all responsibility centers. <i>9/10/02--Partial--Received NJR Service Corp. budget variance reports for 2001 and 2002 to date (the report is not available for 2000 because the service company did not exist at that time). Received NJR Home Services variance reports for 2001 (the report used by Les Davis is the financial statements packet received as a part of OC-18) and 2002 through 7/31/02; as with the service company, Home Services did not exist in 2000. Note that some affiliates, as with Home Services, may not use budget variance reports and instead use financial statements that incorporate budget to actual analysis. Still need the NJNG budget variance report and any other reports for those affiliates that use them. 10/28/02--Complete pending review--Received the July 2002 budget variance report for NJNG. The Company used the 2000 and 2001 financial statements provided for OC-18 as its budget variance reports.</i>	52
C	OC 22	9/6/02	10/1/02	Regulatory / Advice Letters Please provide copies of NJR / NJNG advice letters filed by NJR with the BPU concerning approvals related to affiliates or competitive services since the interim affiliate standards were effective in 2000. <i>10/1/02--Complete--Received a "submittal letter" filed with the BPU regarding the Company's spin-out of its appliance business. The response also refers to the answer given to OC-14 as an example of a letter filed with the BPU asking for a waiver to a subsection of the affiliate rules.</i>	25
C	OC 23	9/6/02	9/17/02	Internal Audit / List Please provide a list of internal audits completed since the beginning of fiscal year 2000. <i>9/17/02--Complete--Received a list of internal audits completed since the beginning of fiscal year 2000.</i>	11

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 24	9/6/02	10/4/02	Employee List Please provide a list of NJR and subsidiary employees with affiliate, business unit (dept.) and responsibility center (subsidiary) designations as of 9/30/00, 9/30/01, and 9/30/02. <i>10/4/02--Complete--Received an employee list for 2000, 2001, and 2002.</i>	28
C	OC 25	9/6/02	9/23/02	Policies and Procedures / Procurement Please provide a copy of NJR procurement / purchasing procedures in effect since the beginning of fiscal year 2000. <i>9/23/02--Complete--Received a copy of NJR's procurement / purchasing procedures. The procedures are dated 7/11/01.</i>	17
C	OC 26	9/6/02	12/19/02	Employee Transfers Please provide: 1. A list of employees transferred between NJNG and affiliates / other business units (including New Jersey Home Services) from the beginning of fiscal year 2000 through the present. Please update this list as necessary through the end of fiscal year 2002. On this list, please provide: Employee name Transferred from Business Unit Transferred from Job Title Transferred to Business Unit Transferred to Job Title Transfer date 2. For each applicable transfer, identify any payments made by the acquiring affiliate to the affiliate from which the employee transferred and indicate the basis for the payment (i.e. pct of salary, etc.). <i>12/19/02--Complete--Received an updated "business unit" listing that contains the remaining business unit descriptions needed for the employee transfer list. 12/6/02--Update--Received a "business unit" listing. It does not appear that all of the business units on the transfer list appear on the business unit list provided. 12/2/02--Partial--The list marked as complete identifies transfers occurring between business units, by business unit number. However, no "business unit" listing was provided to decipher what the numbers represent. Will request that the list be updated to include this information. 10/1/02--Complete--Received a list of "transferred employees" and a response to part 2.</i>	104

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 27	9/6/02	9/13/02	Employee Newsletters Please provide a copy of NJR and/or NJNG newsletters / employee publications for the period October, 2000 through the present. <i>9/13/02--Complete--Received copies of NJR employee newsletters and NJNG customer newsletters for fiscal years 2000, 2001, and 2002 to date.</i>	7
C	OC 28	9/6/02	9/23/02	Customer Service / Scripts Please provide copies of all sales, marketing, customer service, safety and other scripts, suggested language or suggested approaches to dealing with customers or answering customer questions applicable to customer service order / inquiry, field services (IM&R) or marketing employees effective since the beginning of fiscal year 2000. <i>9/23/02--Complete--Received copies of sales, marketing, customer service scripts for fiscal years 2000, 2001, and 2002.</i>	17
C	OC 29	9/6/02	10/1/02	Advertising Provide copy or scripts, as applicable, of all advertising placed in local media that involved NJNG or New Jersey competitive services during the period since the beginning of fiscal year 2000. <i>10/1/02--Complete--Received copies of ads placed in local media for both NJNG and NJ Home Services for 2000, 2001, and 2002.</i>	25

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 30	9/10/02	10/1/02	<p>Customer Information Systems</p> <p>Provide the names of the information systems used to store customer records for sales, marketing, service provision/usage, billing or "care" purposes for the following businesses during the period from the beginning of fiscal year 2000 to the present:</p> <p>New Jersey Natural Gas New Jersey Retail Holdings, including: Home Services Power Services Plumbing Service NJR Service Corporation NJR Energy Services NJR Capital Services, including Commercial Realty & Resources NJR Investments NJR Energy Holdings NJR Energy Corporation, including NJNR Pipeline Company New Jersey Natural Resources</p> <p><i>10/1/02--Complete--Received information regarding the information systems used by NJR's affiliates, including NJNG and New Jersey Retail Holdings. 10/2/02--Received supplemental response indicating additional systems used for Energy Services customers.</i></p>	21
C	OC 31	9/10/02	10/3/02	<p>Business Plans</p> <p>Please provide copies of NJR and NJNG business and / or strategic plans applicable to planning for fiscal years 2000, 2001 and 2002.</p> <p><i>10/3/02--Complete--Granted access to the Company's three-year business and financial plan for 2003-2005. Due to the plan's confidential nature, access to the plan while at the Company is acceptable and completes this request. 10/4/02--A copy of the Company's plan marked "confidential" was provided.</i></p>	23
C	OC 32	9/10/02	12/5/02	<p>Customers / Affiliate Referrals</p> <p>Provide a list of NJNG customers referred to affiliates for fiscal years 2000, 2001 and 2002 to date. (This excludes customers referred to the Retail Holdings business units. It includes customers who may have been referred to NJR Energy Services, CR&R, NJR Investments, etc.)</p> <p><i>Complete. States that NJNG does not refer "retail" customers to any of the requested affiliates. May require a followup to determine if NJNG has "wholesale" customers that it may have referred.</i></p>	86

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 33	9/10/02	10/1/02	Policies and Procedures / Affiliate Standards Please provide copies of policies and procedures applicable to compliance with New Jersey BPU affiliate and competitive services standards not covered in data requests OC-2, OC-3, or OC-26. Please include copies of any policies and procedures involving the transfer or joint use of non-customer specific information between the gas utility and its affiliates, transfer or shared use of trademarks, logos, names, licenses and patents, transfer or shared use of employees, and transfer or shared use or proprietary or purchased / licensed software or information systems. <i>10/1/02--Complete--Received an explanation of where in the Company's Compliance Plan we can find the policies and procedures applicable to compliance with the BPU affiliate and competitive services standards (for items not already addressed in OC-2, 3, or 26.</i>	21
C	OC 34	9/10/02	10/25/02	Customers / Large Customer List Please provide a current list of NJNG's 20 largest customers measured by gas volumes or revenue. (If available, a standard recurring sales report summarizing revenue, volumes and / or similar sales statistics by customer may be substituted for an ad hoc list applicable to precisely 20 customers.) <i>10/25/02--Complete--Received a list of NJNG's 20 largest customers.</i>	45
C	OC 35	9/10/02	9/13/02	Advertising / Bill Inserts Please provide copies of NJNG customer bill inserts for fiscal years 2000, 2001 and 2002 to date. <i>9/13/02--Complete--Received copies of NJNG customer bill inserts of fiscal years 2000, 2001, and 2002 to date.</i>	3
C	OC 36	9/10/02	9/26/02	Customer Service / Customer Requests for Service Please make available / provide access to systems / files containing records of NJNG customer requests and inquiries (service and repair orders and billing inquiries) for gas and appliance service, including requests for service initiation, repair and discontinuation for fiscal years 2001 and 2002 to date. <i>9/26/02--Complete--Received a list of NJNG customer requests and inquiries for services for fiscal years 2001 and 2002 to date.</i>	16
C	OC 37	9/10/02	9/26/02	Internal Audit / Risk Assessment Please provide a copy of the NJR internal audit department's audit risk assessments for fiscal years 2000, 2001 and 2002. <i>9/26/02--Complete--Received audit risk ratings for fiscal years 2000, 2001, and 2002.</i>	16

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 38	9/10/02	12/5/02	Affiliate / Intercompany Service Contracts Please provide a copy of any service agreements or contracts between NJNG and affiliates, including NJR corporate. <i>12/5/02 - Complete. Indicates NJNG / NJR service agreements included in compliance plan (OC_14). Also refers to OC_10 (not provided as of 12/5) and OC_17 (which includes a copy of a bid that HS won for providing propane conversion services to NJNG). 10/2/02--Partial--Received copies of 3 leases, 2 of which are between related parties. The related party leases are a sub-lease between NJNG and CR&R and a sub-sub-lease between CR&R and New Jersey Retail Holdings. At this time, it is unclear if any other affiliate service agreements or contracts exist.</i>	86
C	OC 39	9/10/02	10/3/02	Cost Allocations / Facilities Costs Please provide all documentation to support the collection and assignment and / or allocation of facilities costs to business units and affiliates for budget and regulatory jurisdictional segregation purposes. This should include copies of all building maps, leases, indexes, listings, spreadsheets, and other workpapers documentation containing information used to calculate fully allocated facilities costs and floorspace usage by business units and affiliates. At a minimum, such documentation should show the usage of floorspace, measured in square feet, by affiliate, identify the cost per square foot, separately identify costs (in total and per square foot) for rent, maintenance, security, and utilities. It should include costs at any locations at which facilities costs are collected for budget and regulatory jurisdiction assignment / allocation to business units and / or affiliates. Please provide all maps, documents or spreadsheets required to show the calculation of costs for each type of costs (i.e. rent vs. maintenance vs. utilities) and each location. To the extent the documentation exists in electronic form (i.e. spreadsheets), please provide in electronic form. <i>10/2/02--Partial--Received copies of the main lease agreement between State Street and NJNG and related party lease agreements between NJNG and CR&R and CR&R and New Jersey Retail Services. Received floorplans showing the layout of NJR affiliates/departments and third-party tenants in the Wall headquarters building. Still need notes/workpapers showing the square footage allocations. 10/3/02--Complete--Received square footage workpapers as a part of a supplemental response to OC-7.</i>	23

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC40	9/10/02	10/15/02	Fin Data / GL Transactions Please provide a download, in Excel or Access format, of all general ledger transactions, including all fields, for fiscal years 2000, 2001 and 2002 through July for NJNG, the Retail Holdings units, and any other business unit that rolls into NJNG or NJR for regulatory reporting purposes. <i>10/1/02--Non-responsive--Response refers to where BPU and SEC filings are available. Request asks for general ledger transactional data for NJNG, the retail affiliates, and any other applicable affiliates. 10/15/02--Consider complete--Access to JD Edwards was granted at the client. Requests for activity in specific general ledger accounts will be provided if needed.</i>	35
P	OC41	9/10/02		Policies and Procedures / Customer Service Please provide a copy of all policies and procedures applicable to the call center serving gas customers (and Home Services customers) since the beginning of fiscal year 2000 covering the following subjects: 1. Compliance with New Jersey BPU affiliate standards applicable to call center activities in the areas of non-discrimination, information disclosure, customer enrollment, customer referral, service terms and conditions, response to unsolicited customer inquiries regarding competitive services, the use of the NJNG name in connection with competitive services, etc 2. Allocation of call center assets, operating expenses and efforts / activities between competitive services and traditional regulated utility services, including all procedures relating to timekeeping by employee providing joint / common services. <i>1/13/03--Partial--Received responses to Parts 1 and 2. Part 1 is addressed in the 2001 and 2002 compliance plans. Most of Part 2 has been addressed in other data requests or follow-up e-mail. However, Overland still needs a description of the procedures to allocate call center assets (the physical assets in the center) and the amounts on the books for both NJNG and NJRHS.</i>	184
C	OC42	9/10/02	1/13/03	Cost Allocations / Allocation Factor Support Please provide copies of the source reports for "timesheet" and "equity" used as inputs for the calculation of the corporate cost allocations for fiscal years 2000 through 2003. <i>1/13/03--Complete pending review--The timesheets used for the corporate cost allocation were not provided, but were reviewed at the Company. The equity component is pulled from the financials provided in response to OC-18. Consider complete.</i>	125

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC43	9/10/02	10/15/02	Fin Data / Intercompany Balance Monitoring Please provide the intercompany balance monitoring report pulled through the general ledger system and reviewed by Jason Solimini for each month for fiscal years 2000, 2001, and 2002 to date. Please provide in electronic form if possible. <i>9/10/02--Partial--Received the 6/30/02 intercompany balance monitoring report in hard copy format; still need other months for 2000, 2001, and 2002 to date. 9/23/02--Partial--Received intercompany balance monitoring reports for fiscal year 2002 through July; still need the reports for 2000 and 2001, or if they are not available, a statement that explains why they are not available. 10/15/02--Consider complete--NJR only has these reports starting in 2002, the year that all affiliates were integrated into the JD Edwards system. Have hard copies of 2002 reports (through July).</i>	35
C	OC44	9/10/02	10/2/02	Regulatory / BPU Order re. TEI Please provide a copy of the BPU order implementing the TEI (Transportation Education Initiative) rider. <i>10/2/02--Complete--Received an order adopting a Stipulation in which the implementation of the TEI rider is included.</i>	22
C	OC45	9/10/02	9/23/02	Fin Data / Rating Agency Reports For fiscal years 2000 and 2001, please provide copies of all rating agency reports (S&P and Moody's). <i>9/23/02--Complete pending review--Received rating agency reports from Moody's (draft of a report to be issued in October) and Standard & Poor's (dated April 1998 and August 2002).</i>	13
C	OC46	9/12/02	9/12/02	Affiliate / HS / Appl Svc Contracts Please provide copies of all standard contract forms used by NJR Retail Holdings (Home Services, Plumbing Services, etc.). Examples include home heat, air conditioner, water, and inspection contracts. Provide all contract forms utilized during fiscal year 2000 to the present. <i>9/12/02--Complete--Received the NJR Home Services "contract" for its Protection Plan. The information covers heating system, hot water heater, electric A/C, and annual heating inspection services.</i>	0

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 47	9/12/02	2/26/03	Cost Allocations / Time Studies / Dispatch Please provide copies of all time studies conducted in the Dispatch Department. <i>2/26/03--Update--Received new time study support. The new materials are still under review and their completeness has not yet been determined. After review, consider complete.</i> <i>1/13/03--Complete/Non-responsive--Received a response stating that the materials provided in November are the full package of dispatch time study support. However, Overland's follow-up review of the materials provided revealed that the majority of the support did not relate to the dispatch time studies. It included a summary sheet of the time study data and a variety of support for other topics, such as cost allocation workpapers for other departments. 11/18/02--Partial--Received a variety of time study spreadsheets. A summary sheet covering both time studies was provided. Much of the supporting documentation does not appear related to the time studies. NJR did state that some of the support would be available in the field. Must review more thoroughly to determine completeness.</i>	167
C	OC 48	9/12/02	9/23/02	Cost Allocations / Timesheets Please provide copies of all "affiliate transfer timesheets" used by employees in those affiliates that utilize such sheets. At this time, provide standard templates of the timesheets used, not completed sheets. <i>9/23/02--Complete--Received a sample of NJR's employee timesheet used to track time worked for various affiliates.</i>	11
C	OC 49	9/12/02	10/25/02	Affiliate / HS / Pricing Studies Please provide copies of any studies used to develop Home Services' floor pricing rates. <i>10/25/02--Complete pending review--Received an explanation that Home Services does not have floor prices for its products and services.</i>	43
C	OC 50	9/12/02	1/10/03	Affiliate / HS / Pricing Plans Please provide copies of the pricing plans used by Home Services for all of its product offerings. <i>1/10/03--Complete pending review--Received a product listing including pricing for NJRHS. 12/4/02: Non-responsive-- Analysis of website detail showed many of the services and associated pricing were not provided in response to OC-50. 9/12/02---Received a copy of Home Services' pricing schedule for its protection plans. The schedule is directly from NJR's corporate website.</i>	120
C	OC 51	9/12/02	9/23/02	Cost Allocations / Allocation Data For fiscal years 2000, 2001, and 2002 to date, please provide in electronic spreadsheet form, any cost allocation models not provided in OC-7. <i>9/23/02--Complete--Received in electronic format all cost allocation models not already supplied.</i>	11

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 52	9/13/02	9/13/02	Affiliate / HS / Order re. business transfer to HS Please provide a copy of the BPU Order related to NJNG's transfer of its appliance and repair business / customer account services. <i>9/13/02--Complete--Received the BPU Order.</i>	0
C	OC 53	9/13/02	9/13/02	Affiliate / HS/ NJNG Floor Pricing Petition Please provide any letters sent (including calculations) to the BPU related to NJNG's petition for floor prices for its appliance service contract and non-contract services and any other letters related to the spin-out of Home Services from NJNG. <i>9/13/02--Complete--Received a letter dated June 17, 1999 regarding NJNG's petition for floor pricing. Received a letter dated April 2, 2001 regarding the transfer of assets from NJNG to Home Services.</i>	0
C	OC 54	10/3/02	10/25/02	Affiliate / CRR / Leases to Third Parties Please provide copies of sub-leases between Commercial Realty and Resources and all third parties leasing space within the 1415 Wyckoff building that have been in effect at any time during fiscal years 2000, 2001 and 2002. This should include subleases with, but not limited to, the following: Lyle Corporation Development Dynamic Strategies United Way. Horizon Blue Cross PMK Group CJS Investments RKS Associates <i>10/25/02--Complete pending review--Received the requested sub-leases with third parties.</i>	22
C	OC 55	10/3/02	10/25/02	Affiliate / NJRES / Risk Management Policy Please provide NJR's Risk Management Policy that is referenced in the financial risk management policies portion (in the MD&A section) of the company's SEC 10-k filing. <i>10/25/02--Complete pending review--Received NJNG's Risk Management Policy referenced in the Company's MD&A section of its SEC 10-k filing.</i>	22
C	OC 56	10/3/02	11/13/02	Job Descriptions Please provide all available job/position descriptions for all positions within NRJ and its subsidiaries. <i>11/13/02--Complete pending review--Received job descriptions.</i>	41

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 57	10/3/02	10/4/02	Affiliate / NJR SC / IBS Cost Allocation Packet Please provide a copy (for August 2002) of the Monthly Cost Allocation Packet prepared by Kevin Fornino. <i>10/4/02--Complete--Received the Monthly Cost Allocation Packet.</i>	1
C	OC 58	10/3/02	10/3/02	Affiliate / NJRES / Risk Management Presentation Please provide a copy of the risk management presentation (on natural gas hedging) presented by Joe Shields on April 24, 2002. <i>10/3/02--Complete--Received the risk management presentation on natural gas hedging.</i>	0
C	OC 59	10/4/02	10/4/02	Affiliate / CRR / Order & Stipulation Bldg Sale Please provide the Order and Stipulation related to the sale of the 1415 Wyckoff Road office building from CR&R to State Street. <i>10/4/02--Complete--Received the Order and Stipulation for the sale of the 1415 Wyckoff Road building.</i>	0
C	OC 60	10/4/02	12/4/02	Employee List Please provide, as supplemental information to that provided in OC-24, a new employee list with employee name, affiliate, department, physical location (which building they work in), and supervisor name. Supply this information in an electronic format (Excel or Access). <i>12/4/02--Complete pending review--Received an Excel file showing employee name, affiliate, department number, location, and supervisor.</i>	61
C	OC 61	10/30/02	11/13/02	Regulatory / Selected Orders and Agreements Please provide copies of the following BPU agreements, stipulations, orders, and all related materials: a. 1998 comprehensive agreement with BPU and subsequent stipulation (see p. 38 of the 2003 NJR 3 year business and financial plan (Plan). b. The appliance services business unit spin out agreement, and any related BPU stipulations or orders. (see Plan p. 34) c. Unbundling settlement (Plan p.34) d. Customer Account Services settlement (Plan p.34) e. A copy of the "regulatory agreement reached in 1996 whereby all risks associated with sub-let space in NJNG's headquarters building being borne by CR&R" (Plan p. 46) <i>11/13/02--Complete pending review--Received the requested data (some of the data was provided in OC-52 and OC-59).</i>	14

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 62	10/30/02	11/13/02	<p>Affiliate / NJRES / Stagecoach Contract</p> <p>Please provide the following with respect to NJRES contracts for storage in the Stagecoach field:</p> <p>a) The contracts with PSEG, Orange and Rockland, Con Ed and NJNG (see page 41 of the 2003 NJR 3 Year Financial and Business Plan)</p> <p>b) Any RFPs issued as part of the "open bidding process" in which NJNG participated and a list of the parties to which the RFP was sent.</p> <p><i>11/13/02--Complete pending review--Received a set of contracts for part a) and an explanation for part b). Must review contracts further to determine if they are the requested documents.</i></p>	14
C	OC 63	10/30/02	1/10/03	<p>Affiliate / NJRES / Energy Mgt System</p> <p>Please provide a copy of the following materials discussed in the interview with Joe Shields on October 30:</p> <p>1. Descriptions of MOSI, Zynet and ICE.</p> <p>2a. MOSI month-end summary reports that show balancing of purchases and sales, for both the utility and NJRES, for FY 2002.</p> <p>2b. The presentation to the NJ BPU on the Stagecoach transactions.</p> <p>3. The peak-day capacity study.</p> <p>4. Accounting policies noted in response to the question about internal written gas supply / gas control procedures</p> <p>5. The LGA testimony which describes Joe's background.</p> <p><i>1/10/03--Complete pending review--Received responses to parts 2a and 4. 11/13/02--Partial--Received data in response to parts 1, 2b, 3, and 5. Still need data for parts 2a and 4. 11/15/02--Partial--Received data for part 2a. Utility and NJRES reports were provided for March, 2002 and September, 2002. Need all of the month-end reports for fiscal year 2002. Still need data for part 4.</i></p>	72

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
P	OC 64	10/30/02		Fin Data / Update OC18, 21, 43 for FY 02 Please update, for the complete 2002 fiscal year (data through September 30, 2002): a) the financial statements provided in OC-18 b) the budget variance reports provided in OC-21 and c) the intercompany monitoring reports provided in OC-43. <i>1/22/03--Update/Partial--The Company still has not provided all September 30, 2002 budget variance reports. Specifically, Overland does not have the NJR Service Company budget variance report. 12/30/02--Complete pending review--Received the NJR Home Services (including Plumbing Services) financials. 12/5/02 - Partial - Received all affiliate financials except NJR Home Services and Plumbing Services. 11/13/02--Partial/Incomplete--Received 9/30/02 NJNG financial statements. No other data received.</i>	134
C	OC 65	10/30/02	12/10/02	Business Plans / Affiliates To the extent possible, please provide the fiscal year 2002 business plans for the following affiliates: NJR Energy Services NJR Power Services NJR Home Services NJR Energy Corporation NJR Natural Energy Commercial Realty & Resources <i>12/5/02 - Response indicates copies will not be provided. Anticipate to be made available week of 12/10 on -site.</i>	41
C	OC 66	11/15/02	12/9/02	Auditor Management Letters Please provide, for fiscal years 2000, 2001, and 2002: a) any "Management Letters" sent by the Company's external auditors to NJR or any of its affiliates or subsidiaries (covering any findings, recommendations, etc.) based on their audits. b) management representation letters provided to the Company's external auditors by NJR or any of its affiliates or subsidiaries. <i>12/9/02--Complete--Received the letters requested in Parts a) and b).</i>	24

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 67	11/15/02	12/30/02	Telecommunications Data Please provide, for fiscal years 2001 and 2002, a summary of all telecommunications charges, broken down by location with related employee data per each location. The summary should include costs related to local landline, long distance landline, and wireless communications. If possible, the summary should include a calculation of the telecommunications costs per employee at each location. <i>12/30/02--Complete pending review--Received a response stating that this data is not available in the form requested by Overland. It would take considerable time to produce the requested data. Consider complete.</i>	45
C	OC 68	11/15/02	12/10/02	NJR Board Meeting Minutes Please make available for review during our next field visit, NJR's Board of Director meeting minutes for meetings held in FY 2001 to date. <i>12/5/02 - Anticipate to be made available week of 12/10 on -site.</i>	25
C	OC 69	11/26/02	12/5/02	Affiliate / Shared Officers and Directors Please provide the most current list of the officers and members of the board of directors for New Jersey Resources and all of its affiliates, including NJNG and NJR Home Services. Please note the effective date that each person assumed his / her position. <i>12/5/02 - Complete subject to check. Current list of officers and directors of each company (to be included in FY 02 Annual Shareholder Report) provided. Appears to contain several violations of BPU requirements.</i>	9

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 70	11/26/02	1/10/03	Fin Data / JV Detail / FY 2001 Please provide copies of the following journal vouchers along with all supporting detail for the following transactions for fiscal year 2001: 10/31/00--Business unit 007, Account 26065, Sub 20000, Doc # 7510, Batch 3952900, \$683,031.39 10/31/00--Business unit 002, Account 26065, Sub 00000, Doc # 500, Batch 3933188, (\$514,378.30) 10/31/00--Business unit 101, Account 26065, Sub 00000, Doc # 600, Batch 4204613, \$186,604.15 11/30/00--Business unit 002, Account 26065, Sub 00000, Doc # 503, Batch 3962125, (\$515,860.00) 11/30/00--Business unit 007, Account 26065, Sub 00000, Doc # 502, Batch 3961539, (\$174,358.83) 1/31/01--Business unit 002, Account 26065, Sub 00000, Doc # 530, Batch 3999729, \$2,509,018.00 2/15/01--Business unit 007, Account 26020, Sub 00000, Doc # 306, Batch 4002674, \$1,288,417.00 3/31/01--Business unit 002, Account 26065, Sub 00000, Doc # 205, Batch 4037039, (\$901,841.23) 6/30/01--Business unit 002, Account 26065, Sub 00000, Doc # 205, Batch 4115449, \$602,798.04 6/30/01--Business unit 007, Account 26065, Sub 00000, Doc # 7061, Batch 4113408, (\$256,065.21) 9/30/01--Business unit 101, Account 26065, Sub 00000, Doc # 600, Batch 4253853, \$245,999.73 <i>1/10/03--Complete pending review--Received the missing voucher support. 12/30/02--Still Partial--Received additional copies of data already received. Still missing voucher support for the 2/15/01 transaction below. 12/10/02--Partial--Received support for all but one of the requested transactions.</i>	45

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 71	11/26/02	12/10/02	Fin Data / JV Detail / FY 2002 Please provide copies of the following journal vouchers along with all supporting detail for the following transactions for fiscal year 2002: 10/31/01--Business unit 10000, Account 260634 Sub 00000, Doc # 22, Batch 4259984, \$1,015,923.00 11/15/01--Business unit 007, Account 26065, Sub 00000, Doc # 306, Batch 4272244, (\$1,177,938.00) 12/31/01--Business unit 002, Account 26065, Sub 00000, Doc # 205, Batch 4302118, (\$909,614.18) 1/31/02--Business unit 007, Account 26065, Sub 20000, Doc # 7510, Batch 4323614, \$1,300,743.46 4/30/02--Business unit 007, Account 26065, Sub 20000, Doc # 7510, Batch 4384819, \$1,188,331.71 5/31/02--Business unit 007, Account 26065, Sub 00000, Doc # 7061, Batch 4399713, (\$241,095.88) 6/30/02--Business unit 002, Account 26065, Sub 00000, Doc # 200, Batch 4446088, \$210,500.00 7/31/02--Business unit 002, Account 26065, Sub 00000, Doc # 205, Batch 4470555, (\$487,842.80) 8/31/02--Business unit 101, Account 26020, Sub 00000, Doc # 7, Batch 4502156, \$197,124.06 9/6/02--Business unit 101, Account 26065, Sub 00000, Doc # 306, Batch 4498013, \$95,661.43 12/10/02--Complete--Received support for all of the requested transactions.	14

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 72	11/27/02	12/5/02	Fin Data / Debt Please provide "term sheets" summarizing the terms of: NJNG's long term debt NJR's revolving lines of credit with banks, including Commerce, First Union, PNC, etc. <i>12/5/02 - Complete s.t. check. Provided term sheets for two bank revolving credit facilities (there may be others). Provided long term debt agreement with NJ Economic Development Authority.</i>	8
C	OC 73	11/27/02	12/5/02	Policies and Procedures / Capital Alloc, Loans Please provide copies of any NJR internal capital allocation policies or procedures dealing with loans from the holding company to subsidiaries. <i>12/5/02 - Complete - No formal capital allocation policies were included. Provided general information re. intercompany loans and an NJR summary of intercompany debt.</i>	8
C	OC 74	11/27/02	12/10/02	Business Plans / Affiliates When available please provide FY 2003 business plans for the affiliates listed in OC-65 <i>12/5/02 - Response refers to OC-65 which indicates copies will not be provided. Anticipate to be made available week of 12/10 on -site.</i>	13
C	OC 75	11/27/02	1/13/03	Fin Data / Rating Agency Correspondence Please provide a copy of all written correspondence between New Jersey Natural Gas Company, its parent, or its affiliates AND the following parties in 2001 and 2002: 1) Moody's 2) Standard & Poor's 3) Any other debt rating agency <i>1/13/03--Complete pending review--Received a statement from the Company that they do not have "routine written correspondence with rating agencies."</i>	47

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 76	12/9/02	12/30/02	<p>Affiliate / HS / CAS Stipulation Questions</p> <p>Refer to response to OC-52, specifically, pages 3 and 9 the order provided in response to that request.</p> <p>A. With regard to the "CAS (customer account services) proceeding", a stipulation was executed on July 6, 2000 between NJNG, the Division of ratepayer Advocates, Enron Corp and Shell Energy Services Company. Concerning this, please provide:</p> <p>1. a copy of the stipulation.</p> <p>2. A copy of the pages in NJNG's tariff covering TPS consolidated billing and bill insert services.</p> <p>B. On page 9, the order provided that within 15 days of divesting the appliance services business from the utility, NJNG was to provide the BPU the name of the new affiliate, its officers, net asset transfer proceeds, accounting treatment and pre-tax margins. Please provide a copy of the materials provided to the BPU in compliance with this requirement (requirement 2 n page 9).</p> <p><i>12/30/02--Complete pending review--Received responses to Part A, 1 and Part B. Consider complete. 12/11/02--Partial--Received a response to Part A, 2.</i></p>	21
C	OC 77	12/9/02	1/10/03	<p>Gas Commodity Competitors</p> <p>Separately, for fiscal years 2001 and 2002, please provide lists of third party suppliers who NJNG considers to have actively marketed the gas commodity on a retail basis in NJNG's service area. To the extent known, please indicate for each TPS whether they were actively marketing to residential customers, commercial customers, or both.</p> <p><i>1/10/03--Complete pending review--Received a listing of third party gas marketers for 2001 and 2002.</i></p>	32
C	OC 78	12/9/02	1/10/03	<p>Policies and Procedures / Information Access</p> <p>Please provide a copy of the Information Systems Access Guidelines referred to in Exhibit B, page 2 of the Compliance Plan.</p> <p><i>1/10/03--Complete--Received a response stating that the Information Systems Access Guidelines are in the 2002 Compliance Plan as Exhibit Q. Overland verified the exhibit.</i></p>	32

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 79	12/9/02	1/10/03	Affiliate / Shared Vehicles For 9/30/01 and 9/30/02, please provide the number of vehicles, regardless of the NJR subsidiary balance sheet on which they reside, and regardless of whether owned or leased, assigned to each of the following business units (or to employees of the business units): NJNG (limited to those used by employees of NJNG) NJR Service Company NJR Home Services NJR Plumbing Services NJR Energy Services CR&R <i>1/10/03--Complete pending review--Received a listing with the number of vehicles assigned to the business units requested for 2001 and 2002.</i>	32
C	OC 80	12/9/02	1/13/03	Fin Data / Rating Agency Reports Please provide the following rating agency information: A) Moody's Summary Opinion dated September 18, 2002. (Note: this Opinion may have been provided in response to OC-45, but the data provided for OC-45 does not clearly indicate whether it is a Moody's Opinion or provide the Opinion date.) B) Moody's Opinion Update dated September 13, 2002. (See the Note to Part A.) C) Moody's Liquidity Assessment dated June 5, 2002. D) Any Standard and Poor's information (for example, any new reports) not provided in OC-45. <i>1/13/03--Complete pending review--Received responses to Parts A, B, and D (various S&P documents provided). The Company stated that they have no record of the June 5, 2002 Moody's Liquidity Assessment. Consider complete.</i>	35
C	OC 81	12/9/02	1/10/03	Affiliate / Shared Information Systems Please provide the following information: A) A listing/description of any information systems shared by more than one affiliate. The list should identify which affiliates share each of the systems. B) A description of the time period(s) over which the information systems listed in Part A were developed (or purchased from third parties if not developed internally). <i>1/10/03--Complete pending review--Received a list of shared information systems with the affiliates using the systems, the date acquired, and the vendor.</i>	32

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 82	12/9/02	1/10/03	NJR / Software Capitalization Policy Please provide the following information: A) A written description of the Company's capitalization policy for the costs of developing software for internal use. B) An explanation of whether the current policy described in Part A changed as a result of the issuance of SOP 98-1--"Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." C) If the current policy described in Part A changed because of the issuance of SOP 98-1, provide a written description of the Company's previous capitalization policy for the costs of developing software for internal use. <i>1/10/03--Complete pending review--Received a brief listing of the Company's capitalization policy for Part A. Answers to Parts B and C were provided.</i>	32
C	OC 83	12/10/02	12/10/02	Affiliate / HS / Product Line Profitability Please provide a copy of Home Services product line -based income statement for fiscal year 2002 discussed in the December 10 interview with Wayne Tarney and Roy Churchman. (Provide by Roy Churchman at the end of the interview) <i>Complete. Provided at the end of the interview.</i>	0
C	OC 84	12/11/02	12/11/02	Affiliate / HS / Marketing Plan Please provide a copy of the most current available Home Services marketing plan discussed by Roy Churchman in the interview on December 10, 2002. <i>12/11/02--Complete--Received a copy of the most recent Home Services marketing plan.</i>	0
C	OC 85	12/11/02	12/30/02	Affiliate / HS / Mailing Lists Please confirm our understanding that Home Services' "internal" mailing list (as discussed in the December 10, 2002 interview with Wayne Tarney and Roy Churchman) consists of a list compiled from a database of Home Services contract and other customers, and is not derived from a database of NJNG customers. (If we are incorrect and the internal list is compiled from a list of NJNG customers, please explain how this is done and how HS compensates NJNG.). <i>12/30/02--Complete pending review--Received a confirmation of our understanding of NJRHS's mailing list source data.</i>	19
C	OC 86	12/11/02	12/12/02	NJR / Board of Directors Briefing Package Please provide the briefing package provided to the Board of Directors for board meetings held in 2002. <i>Complete. Provided as requested.</i>	1

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 87	12/20/02	12/30/02	Internal Audit / Intercompany Costs Please provide a copy of the "Intercompany Costs w/ Affiliate Standards" (13R-01) audit report. <i>12/30/02--Complete--Received a copy of the requested audit report.</i>	10
C	OC 88	12/20/02	12/30/02	Customer Service / Appliance Service Bonuses Please confirm our understanding that bonuses paid to call center employees for selling services on behalf of the appliance services affiliate, NJR Home Services, are no longer paid. Also, 1. Please provide the date at which these bonuses ceased to be paid. 2. Please describe the compensation opportunities, if any, that replaced them, or indicate that the bonuses were removed without any additional compensation in a different form being added to replace them. <i>12/30/02--Complete pending review--Received a response concerning the use of "referral" bonuses at NJRHS.</i>	10
C	OC 89	12/20/02	12/30/02	Affiliate / NJRES / NJNG Purchase at Stagecoach Please confirm our understanding from the interview with Alan Denninger that NJNG had an operational need or could benefit financial or operationally from storage that was met by the Stagecoach facilities. Please provide the following: 1. The approximate date that NJNG determined it needed or could benefit from storage. 2. How this need or benefit was determined and what it amounted to (quantity-wise, in terms of estimated savings, additional operational flexibility, etc.) 3. How NJNG determined how much storage (bcf) could be efficiently used (I.e, how NJNG determined that the amount it purchased was the optimal amount). 4. If a business case or other analysis was developed to determine or support NJNG's purchase of the storage, please provide a copy. If nothing written was prepared, please so indicate. <i>12/30/02--Complete pending review--Received responses to Parts 1 through 4.</i>	10
C	OC 90	12/20/02	12/30/02	Affiliate / NJRES / Stagecoach Ecorp Contract Please provide a copy of the contract between NJR Energy Services and Ecorp. <i>12/30/02--Complete pending review--Received a copy of the requested contract. The contract appears to be an unsigned draft copy.</i>	10

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 91	12/20/02	12/30/02	<p>Affiliate / NJRES / Transactions with NJNG</p> <p>Please confirm our understanding that there were no gas or derivatives transactions between NJNG and NJR Energy Services during the three fiscal years ending September 30, 2002, there have been none since and there are no current plans to initiate such transactions in the future.</p> <p>If such transactions have occurred or are planned, please provide the following details:</p> <ol style="list-style-type: none"> 1. Nature of transactions (whether physical gas or derivatives, type of financial instrument, whether sold by NJNG to NJR ES or vice-versa, why the transactions occurred, etc.) 2. Frequency of the transactions 3. Dates or time periods over which the transactions occurred or will occur. 4. Dollar volumes of the transactions. <p><i>12/30/02--Complete pending review--Received confirmation of our understanding that no gas or derivative transactions took place between NJNG and NJRES during the last three fiscal years.</i></p>	10
C	OC 92	12/20/02	1/13/03	<p>Fin Data / Intercompany Balance Monitoring</p> <p>Please update the response to OC-43 to include the months August and September of 2002.</p> <p><i>1/13/03--Complete--Received the August and September 2002 reports.</i></p>	24
C	OC 93	12/20/02	12/30/02	<p>Fin Data / Off-Balance Sheet Items</p> <p>Please provide a list of off-balance sheet (unconsolidated) assets, interests, liabilities or relationships, including assets, interests, or liabilities held by or business or financial activities conducted by special purpose entities, joint ventures, limited liability corporations (LLCs) or partnerships (LLPs) for which NJR or any of its subsidiaries have financial exposure or potential financial exposure.</p> <p><i>12/30/02--Complete pending review--Received a response indicating that the Company has no special purpose entities.</i></p>	10
NR	OC 94	12/20/02		<p>Fin Data / Trial Balances</p> <p>As a supplement to OC-20, please provide the full fiscal year 2002 trial balances through September in electronic format. (Note: we only have 2002 trial balances through August.)</p> <p><i>1/16/03--Non-responsive--Received updated trial balances for NJ Natural Energy (hard copy), NJR Plumbing (hard copy), NJR Energy Services (hard copy), and NJR Services Company (hard copy), as well as several electronic versions, including CR&R, NJR Investments, NJR Energy, NJNR Pipeline, and NJR. However, Overland did not receive an updated trial balance for NJNG in either hard copy or electronic form. Other NJNG trial balances were provided in electronic form. Overland does not believe that it would be extremely time consuming to include one additional month of trial balance data in an updated response.</i></p>	83

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 95	12/26/02	1/13/03	<p>Affiliate / HS / Appliance Procedures</p> <p>This request is to confirm and clarify certain information about appliance services.</p> <p>1. Please list which of the following services are provided by NJNG, which, if any, are provided by NJR Home Services and which may be provided by both. If varying procedures apply, please briefly explain the circumstances. Please note that the request is intended to cover generally applied procedures, not procedures that might hypothetically apply in the unusual exception or rare circumstance.</p> <p>2. Please indicate whether or not the utility-provided services are provided free of charge. If there is a charge, please indicate what it is. If varying proCedures apply, please briefly explain the circumstances.</p> <p>3. Please indicate whether services provided by NJR Home Services are provided free of charge, included in service contracts (if the customer has one), and / or charged for separately. If varying proCedures apply, please briefly explain the circumstances.</p> <p>a. Appliance pilot lighting at time of meter turn on.</p> <p>b. Appliance pilot lighting at times other than meter turn on.</p> <p>c. Original adjustments on new appliances at meter turn on.</p> <p>d. Original adjustments on new appliances for existing customers.</p> <p>e. Normal pilot adjustment, months other than September or October</p> <p>f. Normal pilot adjustment, November through August (note months if varying procedures apply).</p> <p>g. Investigation of gas leaks and safety-related calls.</p> <p><i>1/13/03--Complete pending review--Received a response addressing Parts 1 through 3.</i></p>	18

Resp.	Dr No.	Date Sent	Date Received	Description	Elapsed Days
C	OC 96	1/27/03	3/4/03	Affiliate / HS / Going Concern Transfer Regarding Home Services customers and the internal mailing list of service contract customers: 1. When Home Service established operations at the end of 2000 or beginning of 2001, did it compensate NJNG for the value of the appliance service contract revenues and customer relationships that were transferred? Overland assumes this to be unlikely to have occurred; however, if it did occur, please explain how much the compensation was and how the amount was determined). If not, please so state. 2. Did Home Services compensate NJNG for the list of appliance service customers and associated customer data when it was transferred at inception? If so, how much did it pay and how was the amount calculated (provide support if available). If there was no compensation, please so state. 3/4/03--Complete--Received response addressing the questions posed in this request. Much of the data was provided separately on 3/3/03.	36
C	OC 97	1/27/03	3/4/03	Affiliate / HS / Collections Please provide the following information regarding the credit and collections function at NJNG and NJR Home Services: 1) The overall bad debt rates for both NJNG and NJR Home Services. 2) The collections costs paid by NJR Home Services to NJNG for this function. 3) A description of the allocation factors used to determine the amount of collections costs related to NJR Home Services. 4) The 2001 and 2002 NJR Home Services collections costs. 3/4/03--Complete--Received responses addressing the request. Consider complete.	36
Average Elapsed Days:					39